EMERGING MARKETS FORUM

BACKGROUND PAPER

SOUTHEAST ASIA'S POTENTIAL FOR ACCELERATING GROWTH

Emerging Markets Forum

Southeast Asia’s Potential for Accelerating Growth

Centennial Asia Advisors, June 2024

This chapter sets out the argument that Southeast Asia is well-positioned to enjoy a material economic acceleration, sufficient to make it a global pole of economic dynamism as well a prominent destination for foreign direct investment in the coming decades. The analysis below identifies the factors that support this growth trajectory while also assessing what might impede the region’s progress.

Section 1 describes the region’s strong starting point and how it has finally overcome two key shocks that have handicapped the region for many years. The first was the Asian Financial Crisis whose long term scarring effects undermined the region’s once eminent position as a hotbed for foreign direct and portfolio investment. The second was the competitiveness shock from China’s surge, which helps to explain the signs of premature deindustrialization.

Section 2 acknowledges that realizing the region’s full economic promise over a long period of several decades requires overcoming significant challenges. Global and regional geopolitical tensions, as well as rising trade disengagement and geoeconomic fragmentation, will act as headwinds in a region that is heavily dependent on exports and foreign investments. Climate change and extreme weather events also threaten the region's agriculture-dependent economies, potentially leading to food insecurity and social instability. Domestic political challenges have also emerged, with recent crises and risks of democratic backsliding.

In Section 3, we identify a confluence of forces coming into play, the product of both global trends as well as strategic responses which could propel faster growth in Southeast Asia in the coming decades. A confluence of tailwinds is falling into place including supply chain reconfiguration, good demographic dividends, policy reforms, and infrastructure development. Sound policy responses at country and regional levels will be needed to promote the regional cooperation, productivity enhancements, and climate change mitigation strategies that will be crucial in navigating these hurdles and achieving sustainable growth.

SECTION 1: SOUTHEAST ASIA HAS BUILT A GOOD FOUNDATION FOR GROWTH

A region of growing strategic importance and growth potential despite a chequered history

Since the mid-1980s, Southeast Asia's economic trajectory has been volatile. Economic reforms unleashed impressive growth, but this surge was thrown off track by the Asian Financial Crisis (AFC) of 1997 which triggered a systemic crisis in several parts of the region. Despite overcoming the worst effects of this crisis by the early 2000s, the region has been unable to replicate the extraordinary dynamism it enjoyed in the early 1990s. Nevertheless, it has also demonstrated a clear degree of resilience, rebounding from shocks such as the Global Financial Crisis (GFC) in 2007, the so-called taper tantrums of 2013 and the pandemic of 2020.

After a long period of under-performing its potential, Southeast Asia now has a firm base on which to build its future. The region is strategically positioned between China and India, giving it the ability to leverage off the immense economic opportunities presented by growth in these Asian giants. The region already possesses several clusters of globally competitive manufacturing activities which are set to expand as the foreign investment flows that have strengthened in recent years translate into factories, new supply chains and better quality jobs. Its population of 686 million is projected to grow by 0.85% per annum[1] and while smaller than China or India, the region offers a large enough work force to be of interest to foreign investors. Except for Myanmar which is embroiled in a nasty civil war, the region is largely peaceful and stable.

These economies, grouped under the Association of Southeast Asian Nations (ASEAN), are now collectively the fifth-largest economy globally, generating 6.4% of the world's GDP. , and serving as a major hub for manufacturing and trade. The value of regional trade in Southeast Asia is approximately one-third that of the United States. Projections indicate that Southeast Asia will become the world's fourth-largest economy by 2040, following the United States, China, and India, with an expected compound annual growth rate of 4% between 2022 and 2040[2].

Its geographic position as well as its economic potential combined with its position astride major sea lanes of communication such as the Malacca Straits and the South China Sea to give it a prominent geo-strategic position as well. This has made it a major arena for big power contestation as well.

Overall, the region has overcome its setbacks and has built a good foundation on which to develop more rapidly.

First, the region's improved resilience puts the financial shocks of past years well behind it

In essence, improved macro-economic management and better financial sector regulation have reduced the risks of interruptions to growth caused by shocks related to currency weakness, current account deficits or banking crises.

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[1] International Monetary Fund (n.d.) IMF Data Mapper: Labor Productivity

[2] Australian Government Department of the Prime Minister and Cabinet (January 2024) [Fact Sheet]

In the late 1980s and 1990s, the region was a major destination for foreign direct and portfolio investment. This, however, changed post-AFC as the crisis triggered the largest financial bailouts by international financial institutions (IFIs) in history and ended decades of robust economic growth in Asian economies (see chart below). The aftermath of the crisis left companies scarred and caused them to take a long time to deleverage and regain confidence. Banks became extremely cautious about lending, causing a severe contraction in portfolio investment and weakening foreign direct investment (FDI). Net capital inflows of USD 93bn into the five most affected Asian economies (South Korea, Indonesia, Thailand, Malaysia, and the Philippines) in 1996 were replaced by a net capital outflow of USD 12bn in the second half of 1997. Most of this shift resulted from a USD 73bn reversal in net bank lending flows, with the sharpest outflows seen in Thailand and Korea[3].

GDP growth in ASEAN has seen its ups and downs

Source: CEIC

Those setbacks are today a thing of the past. One key factor behind its stronger position is the region's improved resilience. Despite facing severe economic disruptions, currency devaluations, and financial instability due to events such as the 1997 Asian Financial Crisis (AFC) and 2008 Global Financial Crisis (GFC), the region as a whole continued to exhibit growth, growing from USD 0.5tn in 1993 to USD 1.6tn in 2008 and USD 3.6tn in 2022. It has taken some years but the region has improved the various elements of its resilience.

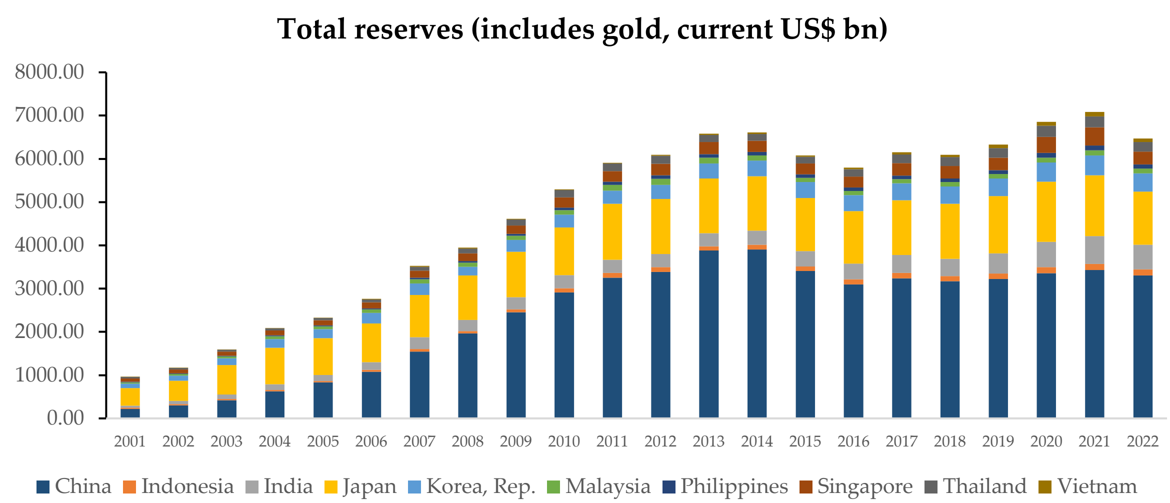
For one, countries have ensured a sounder exchange rate regime. In the years leading up to the AFC, Asian economies operated on a quasi-pegged exchange rate regime. This not only invited speculation and hindered the ability of economies to adjust to external shocks, but the maintenance of pegged exchange rates to the US dollar also encouraged more external borrowing, leading to excessive exposure to foreign exchange risks in the financial and corporate sectors. Post-AFC, the region mostly operated on flexible exchange rate regimes. This allows currencies

[3] International Monetary Fund (1997) The Asian Crisis: Capital Markets Dynamics and Spillover

to adjust in response to market conditions, reducing the risk of speculative attacks and providing greater monetary policy autonomy.

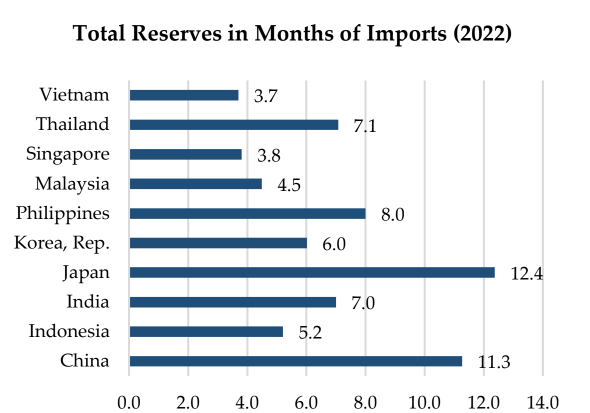
Additionally, after the exchange rate collapse during the Asian crisis, countries have been building up international reserves, enabling them to better defend their currencies. Data has shown that Asia performs soundly in this regard; when looking at the import cover ratio, all Asian economies are above the benchmark of three months of coverage. Likewise, the benchmark for the reserves to short-term external debt ratio is typically a 100% cover; Asian economies also excel on this metric, with the exception of Malaysia which has the lowest ratio at 0.81.

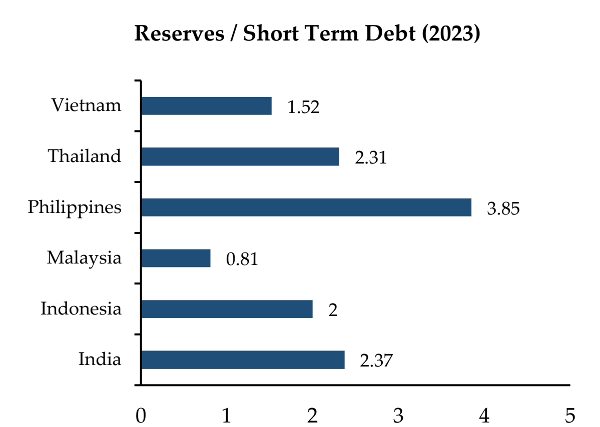
ASEAN has built up a steady flow of reserves over the years



Source: The World Bank (World Development Indicators)

Asia maintains safe levels of reserves





Source: The World Bank (World Development Indicators), International Monetary Fund

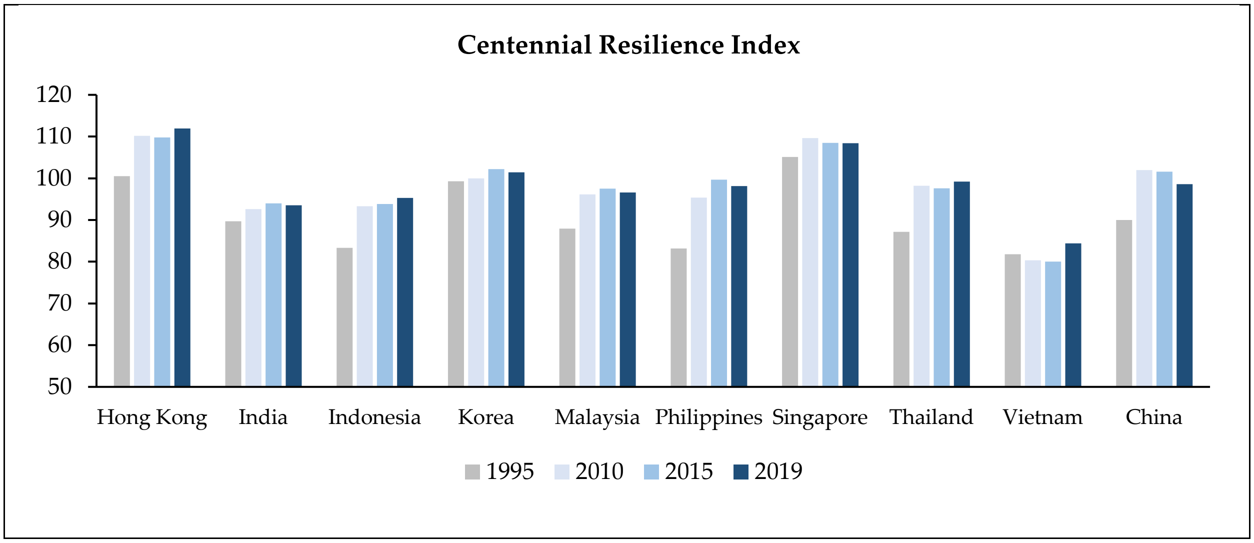
Countries across Southeast Asia have also made notable strides in fiscal management. Countries are increasingly disciplined in their fiscal management, which has prevented excessive government borrowing and debt accumulation. This reduces the risk of macroeconomic imbalances and allows for more effective and credible government interventions during economic crises, ensuring that support measures are both timely and sustainable. Indonesia is a prime example of this case; it has implemented a fiscal rule that limits the budget deficit to 3% of GDP. According to the International Monetary Fund, Indonesia's general government gross debt as a percentage of GDP is just 39.3%, much below the ratio for its emerging market peers such as India (82.5%) or Brazil (86.7%).

In addition, countries in the region have adopted inflation-targeting frameworks for monetary policy. Thailand adopted an inflation-targeting framework in 2000, aiming to keep inflation within a range of approximately 1.5% to 3.5%. Similarly, the Philippines introduced its inflation-targeting framework in 2002, setting a target range of around 2% to 4%. These frameworks help central banks manage inflation expectations and provide a transparent approach to monetary policy, contributing to overall economic stability.

Finally, after the AFC, Asian regulatory authorities recognized the crucial role of having adequate capital to ensure the stability of banks and the broader financial system. They introduced higher Capital Adequacy Ratios (CAR) for banks, requiring them to maintain significant capital buffers proportional to their risk exposures. This ensures that banks are better able to absorb potential losses and protect depositors' funds, particularly during times of economic stress or downturns. These measures serve as protection against unexpected shocks and uncertainties, decreasing the likelihood of bank failures. Moreover, the increased CAR requirements have enhanced market confidence in the financial sector, as investors and depositors see banks as more resilient and able to endure adverse economic conditions. Consequently, credit flows to the wider economy have stayed relatively stable despite macroeconomic fluctuations, preventing sudden credit shortages and supporting both growth and stability goals.

The results were clear in the diverging regional performance during the 2013 "taper tantrums" and more recent disturbances in financial markets. In 2013, the hint from then Federal Reserve Bank Chair Ben Bernanke that US monetary policy might be tightened was sufficient to trigger significant currency depreciations in Southeast Asia, with the Indonesian Rupiah, for example, weakening sharply. During more recent periods of global instability such as the pandemic or the turbulence caused by the crisis in the US over regional banks in 2023, the regional currencies largely have held firm, attesting to the strengthened resilience.

Improving economic resilience is a key factor for ASEAN



Source: Centennial Asia Advisors

Second, by now, the region has also weathered the China shock

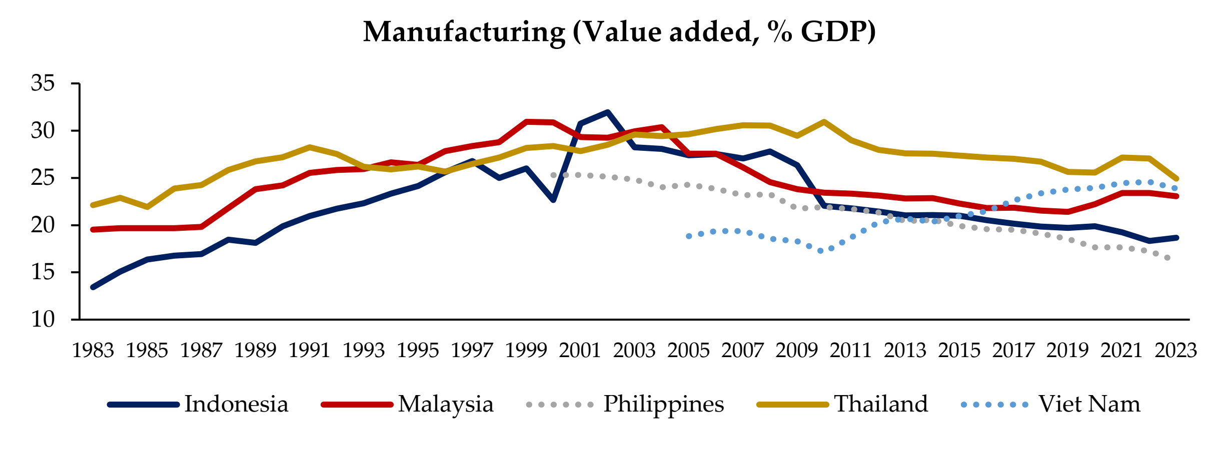
Just as the Southeast Asian region was finding its feet after the Asian Financial Crisis, it faced another set of headwinds that came from China's economic surge. While it is true that China's economic development opened up new opportunities for Southeast Asia, there were two areas where the impact might have been less helpful.

In the late 1990s, as China was negotiating its accession to the World Trade Organisation, global manufacturers reviewed their portfolio of manufacturing locations and decided to substantially increase the weight of China in their portfolio. There followed a period of several years when there was a significant reallocation of capital to China, away from countries such as those in Southeast Asia which had been until then major beneficiaries of foreign direct investment. As the relatively small Southeast Asian economies depended disproportionately on foreign investment flows to propel their economic development, this reallocation of capital hurt the region's growth prospects for an extended period.

Separately, China's rapid economic growth also sparked off a boom in commodity prices which, at first cut, provided a boost to Southeast Asia's growth through the great upswing in the prices of commodities they exported such as coal, base metals, rubber and crude palm oil. However, a there was a less benign dimension to the commodity boom. Content with the economic growth they saw, policy makers became complacent and neglected the hard work needed for sustained economic transformation – such as reforming the labour market, building sound infrastructure, encouraging human capital development and nurturing an eco-system that encouraged businesses to invest for the long term.

Since these elements were particularly needed for inspiring expansion of the manufacturing sector, it was not surprising that some countries in the region experienced premature deindustrialization. This refers to the economic phenomenon where "developing countries are turning into service economies without having gone through a proper experience of industrialization"[4]. Since the 1980s developing countries have witnessed a decline in manufacturing employment and output at much lower levels of income compared to early industrializers. Southeast Asian countries are thus finding it challenging to develop more advanced industries essential to transition to productivity-led growth. Without this transition, Southeast Asia risks a future where it specializes in the exports of raw materials, agricultural products, and lower-order goods while relying on more advanced manufactured imports from the region's dominant economies. This places Southeast Asian producers at a disadvantage where they face intense competition from Chinese imports.

Some economies in Southeast Asia are at risk of premature deindustrialization



Source: World Bank Open Data

Indonesia stands as a case in point. In the 1990s, before the AFC, Indonesia's real growth reached a high of 8.2%, driven by a shift in workers out of agriculture into higher-productivity manufacturing. This, however, did not last long. As a result of the strong external demand for trade liberalization — which first started in 1995 when Indonesia entered the WTO — the country had to significantly reduce its trade barriers. As Indonesia had yet to develop a strong comparative advantage in manufacturing, the sector soon lost to intense global competition. After the AFC, manufacturing growth began to taper off and eventually diminished in importance after reaching a peak of 32% of GDP in 2002.

Malaysia, too, began to deindustrialize in the late 1990s after the AFC. This, however, coincided with the rapid industrialization of China which effectively outpaced that of Malaysia, leading to a loss of competitiveness in Malaysia's manufacturing industries. Consequently, Malaysia's manufacturing sector's share of GDP declined from 31% in 1999 to 23% in 2010, while its share of employment fell from 23% to 17% over the same period. The manufacturing sector's contribution to GDP stood at 21.4% in 2019, down from a peak of 30.9% in 1999[5]. The rapid pace of deindustrialization in Malaysia, occurring when the country's per capita income was lower than that of more advanced economies, left Malaysia unprepared. The country lacked the necessary resources to make quality investments and spend adequately on R&D, leading to several

[4] Rodrik (2015) Premature deindustrialization
[5] ASEAN+3 Macroeconomic Research Office (December 2023) Malaysia: From Deindustrialization to Revitalization

challenges in transitioning to high-value-added segments of manufacturing. This has resulted in an overall drag on the economy, preventing Malaysia from realizing its full potential.

Now that more than twenty years have passed since China entered the World Trade Organisation, this process of capital reallocation away from Southeast Asia has played out. Now new forces are emerging which are promoting the reflux of capital back into Southeast Asia – as we explain in the following section.

SECTION 2: WHAT COULD IMPEDE SOUTHEAST ASIAN'S REVIVAL?

The Southeast Asian economies are open and thus exposed to a global environment that is increasingly marked by potential downside risks. The geo-political contestation between the US and China has as its main arena the immediate environs of Southeast Asia. Growing protectionism is another challenge for these open economies. Then there are newer risks such as climate change. Finally, some countries in the region face domestic political woes.

A challenging external environment may threaten Southeast Asia's stability

ASEAN is located between India and China and straddles sea lanes of communication that are of critical value to China and the US. The region also serves as a major source of raw materials, energy, and manufactured components - which means that the big powers also have substantial stocks of foreign investment in the region. In addition, there are ongoing disputes over sovereignty over parts of the South China Sea.

This strategic importance draws the big powers into the region and, unsurprisingly, geopolitical tensions have been escalating. A notable example is the increased military activity in the South China Sea, a critical maritime region through which a significant portion of the world's trade passes. Confrontations between the Philippines and China have become more frequent, with both nations asserting their territorial claims. These confrontations not only threaten regional stability but also disrupt maritime trade routes crucial for global commerce.

The ongoing rivalry between China and the United States results in both powers actively courting ASEAN countries individually, seeking to win them over to their respective sides. China, for instance, is investing heavily in infrastructure projects across ASEAN countries through its Belt and Road Initiative to foster closer economic ties and increase its influence in the region. The United States, on the other hand, has been strengthening its military alliances and partnerships with ASEAN countries. The US has conducted joint military exercises, provided military aid, and engaged in diplomatic efforts to counterbalance China's influence.

However, if tensions between the two superpowers escalate, Southeast Asian countries may be pressured to align with one side. The situation could worsen if the U.S. tightens restrictions against countries that are seen as too closely aligned with Chinese technology and firms. Already, the US has pressured Japan and the Netherlands to impose restrictions on China's semiconductor sector. There is a possibility of similar measures being directed at Southeast Asian nations that become too involved with China.

The backlash against trade opening is another risk

Economically, the ASEAN region is heavily dependent on export markets, foreign investment inflows, and tourism. However, growing trade disengagement and geoeconomic fragmentation are posing significant challenges. The increasing rivalry among major powers has led to many economies turning inward, imposing trade restrictions, and pursuing policies that favour domestic producers over exporters. This inward-looking trend, a sign of "slowbalisation", is detrimental to the region's economic health.

The situation is further exacerbated by the actions of the United States, which has undermined the World Trade Organization (WTO) by crippling its appellate functions. This weakening of the global trade framework adds to the uncertainty and instability in international trade relations.

The global impact of these developments is concerning. The WTO has projected that a global trade conflict could lead to a reduction in global GDP of about 1.96% and a reduction in global trade of about 58%[6]. This highlights the severe economic consequences of geoeconomic fragmentation. Additionally, a study by the Asia-Pacific Economic Cooperation (APEC) divided its member economies into three blocs and found that cross-bloc trade restrictions negatively impact APEC trade across almost all sectors, with exceptions only in the food and digital sectors. Even economies that remain neutral suffer trade losses, indicating the widespread unintended repercussions of restrictive trade policies. An analysis by geographical region shows adverse effects throughout APEC, with varying degrees of impact, underscoring the pervasive nature of the negative impacts on trade[7].

These trends in protectionism and "slowbalisation" threaten access to both developed and developing markets for regional exporters, undermining economic growth and stability in the ASEAN region.

The region's diversity could create challenges to its collective coherence

Despite its collective economic strength, Southeast Asian countries are a diverse lot. Indonesia, Vietnam and the Philippines are large countries which are expanding rapidly. Singapore and Brunei are already affluent and their growth rates are slower. Thailand and Malaysia developed rapidly in past years but now risk being caught in the middle-income trap. Myanmar, Laos and Cambodia have much lower income levels. In 2022, average annual incomes ranged from USD2,310 in Laos to USD67,200 in Singapore. Indonesia, with annual incomes of USD4,580, has the largest economy, constituting more than a third of Southeast Asia's GDP. The next five largest economies—Thailand, Singapore, Philippines, Vietnam, and Malaysia—each contributed approximately 10-15% of the region's economic output.

The global economic turbulence following the end of the pandemic has also highlighted these intra-regional economic differences. Singapore, heavily dependent on global trade, saw its growth rate fall to 1.1% in 2023 as the global economy slowed. Conversely, Vietnam, with its manufacturing base, low-cost production, and strategic proximity to China, benefited from the shift to a China Plus One supply chain strategy, maintaining a steady growth rate of 5.1% in 2023[8].

Costs of climate change will become more apparent in the coming years

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[6] World Trade Organization (2019) POTENTIAL ECONOMIC EFFECTS OF A GLOBAL TRADE CONFLICT: Projecting the medium-run effects with the WTO Global Trade Model

[7] APEC (May 2024) Win, Lose or Draw: Estimating the Impact of Trade Disengagement on APEC Trade

[8] Lowy Institute (March 2024) The parts within the whole: Understanding Southeast Asia's economies

More extreme weather patterns, rising sea levels, and higher temperatures are likely to be more evident in the coming years. Statistics show that temperatures this year are at the highest since record-keeping began and countries around the world are all struggling with heat waves that are getting hotter and longer. Besides long-term warming, non-regular climate phenomena such as El Niño, which typically brings about precipitation to the Pacific Coast of the Americas and drier conditions to Asia and Australia, introduce abnormal weather patterns such as droughts, flooding and wide fluctuations in temperature. Such extreme weather events will weigh on Southeast Asia's economy, especially as many Southeast Asian countries rely on agriculture, with the sector accounting for a large portion of their GDP.

First, as a large proportion of household spending in these economies is on food, it often constitutes the largest category in the consumer basket. As such, food shortages often trigger large degrees of inflation and disproportionately affect real purchasing power. In the long run, a lack of nutrition stunts an individual's development and educational attainment, dragging down the emerging economies' human capital development and potential growth.

Second, there is a risk that a short-term food shock could lead to a long-term decline in production. When farmers are faced with a loss of income, they are forced to sacrifice their productive farming capital in exchange for basic sustenance, leaving them with insufficient capital to operate their farms and precipitating a migration to the urban areas in search of work. The result is a permanent decline in agricultural output for the country and the world.

Third, the increased prevalence of food insecurity will have profound effects on social and political instability. After all, food is a fundamental commodity that states are responsible for providing access to; failing in this regard undermines state authority. Historically, numerous Chinese emperors lost their "mandate of Heaven", or their right to rule, after failing to tackle famines. More recently, the steep hikes in global food prices during the 2007-2008 world food crisis, brought about street demonstrations and food riots in more than 40 countries. Closer to home, the soaring food prices in the Philippines were declared an "emergency situation" by President Marcos Jr., leading to protests during his keynote first-year-in-office speech.

Fourth, the increased prevalence of food insecurity will likely lead to a more 'inward-looking' or 'selfish' mentality among countries. In response to the problem of food shortages, governments have adopted an increasingly nationalist attitude towards food security, most commonly in the form of export restrictions. Unfortunately, such beggar-thy-neighbour measures can trigger a chain effect. As countries impose export restrictions, they introduce uncertainty to the global food markets and induce upward pressures on prices. This creates a situation of panic, forcing other exporting countries to consider imposing restrictions to protect their domestic interests. Indeed, this was what happened in the 2007/08 food price spike where the price of the benchmark Thai rice almost tripled between October 2007 and April 2008. As a further cause for concern, there is evidence of export restrictions staying longer than intended. As of February, one year after the outbreak of the Ukraine War, 101 export restrictions imposed at the height of the war remained in place, suggesting that countries are putting national interests far ahead of free trade principles.

Lack of capabilities may hinder Southeast Asia's ability to prosper

Southeast Asia's economic landscape is fraught with challenges that could potentially impede its growth trajectory. Two significant issues stand out: the region's unreliable electricity supply and the shortage of skilled labour. These problems, if not addressed, could undermine investor confidence and hamper long-term economic development.

Concerns regarding electricity supply in the region are well-founded. Even in recent years, there have been reports of power shortages across Southeast Asia. In 2023, Northern Vietnam reported a series of blackouts caused by a heat wave and drought, drying up the reservoirs of hydropower plants where Vietnam gets about 43% of its power and forcing factories to cease operations, severely affecting businesses' outputs and business profits. It did not help that Northern Vietnam is one of the major economic regions in the country, accounting for more than 32% of national GDP and 26% of total FDI capital in the country[9]. Likewise, a five-hour power shortage that occurred in May 2023 in the Philippines was estimated to cost the country about PHP 556mn in economic losses[10]. Such reports of power outages will only dampen investor confidence due to the toll it takes on business profits.

Besides, while Southeast Asia boasts of a large, youthful population that helps to lower labour costs, there remains a shortage of skilled workers in critical sectors. Plausible reasons for this include a relatively lower percentage of graduates compared to developed Asia, as well as a lack of supply and access to education and re-training at later stages of life.

Indonesia, for instance, has only an estimated 55mn skilled workers out of a labour force exceeding 136mn people. According to the Master Plan for the Acceleration and Expansion of Economic Development in Indonesia (MP3EI), the country will require 113mn skilled workers by 2030 to meet the demand for skilled jobs. Likewise, the Philippines has reported a shortage of skilled labour. This shortfall is amplified by the issue of 'brain drain' prevalent in the country, where a sheer number of people in the country are opting to work overseas in search of better prospects[11]. Without a sufficiently skilled workforce, Southeast Asia may face challenges to long-term growth, as a skilled workforce is essential to help a country adapt to massive changes brought about by technology.

The issue of a shortage of skilled workers is particularly concerning to Southeast Asia given its heavy reliance on the textiles, clothing, and footwear (TCF) and low-cost electrical and electronics (E&E) sectors which are extremely susceptible to job displacement by automation. A study by the International Labour Organization (ILO) found that nearly 56% of all employment in five ASEAN member states—Cambodia, Indonesia, the Philippines, Thailand, and Vietnam—could be at high

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[9] Asia Pacific Foundation of Canada. (2023). Northern Vietnam Plunged Into Darkness as Power Crisis Prompts Investor Concerns.

[10] Philippines Institute for Development Studies. (2023). Power outage woes: Philippines faces P556 million economic loss in five hours.

[11] ASEAN Briefing. (2022). Assessing the Current Human Resources Talent Pool in ASEAN

risk of automation in the next two decades[12]. The vulnerability of low-skilled Southeast Asian workers thus makes it all the more important for the government to upskill their workers.

Messy domestic politics are a potential risk

Domestic political systems and governance performance across Southeast Asia vary greatly, with some countries faring better than others. More developed economies in the region, such as Singapore and Malaysia, score highly in the governance metrics, but other developing Southeast Asian nations such as Cambodia, Myanmar, and Laos are struggling. In recent months, Thailand has also been showing signs of political instability as the governing coalition is showing increasing signs of fragmentation. Meanwhile, the impending dissolution of the reformist Move Forward Party threatens to trigger a new wave of mass protests., raising concerns about potential coups and further instability. Myanmar has the worst showing in the region. Since the 2021 coup, Myanmar has plunged into a deep crisis, even attracting the attention of global organizations such as the United Nations. Persistent clashes between the military junta and various ethnic armed groups have exacerbated political instability, leading to economic downturns and humanitarian crises. These events have significantly undermined investor confidence and will adversely affect the long-term trajectory of the region.

Table 3: State of governance across Southeast Asia differs greater among countries

	Government Effectiveness	Political Stability	Regulatory Quality	Rule of Law	Control of Corruption	Average
Indonesia	0.44	-0.44	0.21	-0.19	-0.43	**-0.08**
Cambodia	-0.35	-0.04	-0.71	-0.87	-1.24	**-0.64**
Lao PDR	-0.60	0.80	-0.99	-0.81	-0.97	**-0.51**
Myanmar	-1.68	-2.21	-1.24	-1.53	-1.15	**-1.56**
Malaysia	0.99	0.14	0.64	0.56	0.25	**0.52**
Philippines	0.06	-0.71	0.06	-0.52	-0.54	**-0.33**
Singapore	2.14	1.46	2.21	1.78	2.09	**1.94**
Thailand	0.13	-0.38	0.17	0.07	-0.45	**-0.09**
Vietnam	0.18	-0.03	-0.43	-0.16	-0.29	**-0.15**

Source: World Governance Indicator, compiled by Centennial Asia Advisors | Scores ranging from 0.5 to 2.5 are represented in green, indicating strong performance. Orange is used for scores between -0.5 and 0.5, showing moderate performance. Light pink represents scores from -1.5 to -0.5, indicating weak governance. Scores below -1.5 are marked in brown, reflecting very poor governance.

Conclusion: To prosper, Southeast Asia needs to address these constraints

All things considered, conditions are certainly in place for Southeast Asia to grow; the region's demographics, improving infrastructure, burgeoning digital landscape, and regional integration are clear indicators of its potential. However, sustaining growth beyond the demographic dividend, early-stage reforms, and supply chain reconfigurations will require a strengthening of

[12] Arifin (2018) *What Are the Effects of Automation on the ASEAN Workforce?*

resilience to face an increasingly volatile and riskier world. To prosper, there is a need to overcome the hurdles mentioned above. Various recommendations:

- Southeast Asia must continue to capture a greater share of global trade flows, and this can be achieved by enhancing regional cooperation and expanding free-trade agreements, especially in a time of deglobalization. Governments must also be open to reforms to tackle restrictions on foreign investment.
- Southeast Asia must continuously improve the quality of its human capital. It helps that the labour force/relatively larger workforce is available to tap on (which is a unique advantage for SEA); upskilling the workforce to attract the highest value-added sectors, help with economic growth. A report by the OECD suggested that a diverse set of skills – including foundational skills, transversal cognitive and meta-cognitive skills, and professional technical, and specialised knowledge and skills - are essential for Southeast Asia's response to global megatrends such as globalization, technological progress, etc. Must have policy reforms to ensure citizens are well-skilled.
- Deploying disruptive technologies across sectors will also drive major productivity improvements and modernize industries. Important because emerging technologies may help to resolve the quandary of low productivity. Technology plays a crucial role in enhancing productivity by automating tasks, enabling predictive and analytical functions, and ultimately leading to a permanently higher growth rate in the economy. Especially important for SEA which is so heavily reliant on manufacturing and agriculture.
- Address climate change; Climate change is an existential threat, but it also represents a massive opportunity for Southeast Asia to pursue low-carbon economic growth. One of the ways to do so: Southeast Asian countries can take advantage of strong demand for green bonds to advance their net-zero goals. What is encouraging: As of the first half of 2022, ASEAN countries have raised a cumulative $38 billion from green and SDG or thematic bonds.

SECTION 3: FACTORS THAT CAN SUSTAIN GROWTH OVER THE LONG TERM

Given the challenges described above and the ever-present risks of falling into a middle income trap, is the Southeast Asian region doing enough to boost its economic development potential for the longer term, beyond just the next decade or so?

As we set out below, a confluence of forces is coming into play involving strategic responses to a troubled environment as well as favourable global trends that will support a prolonged period of growth and transformation in the region.

Supply chain reconfiguration will benefit Southeast Asia via increased investments and trade

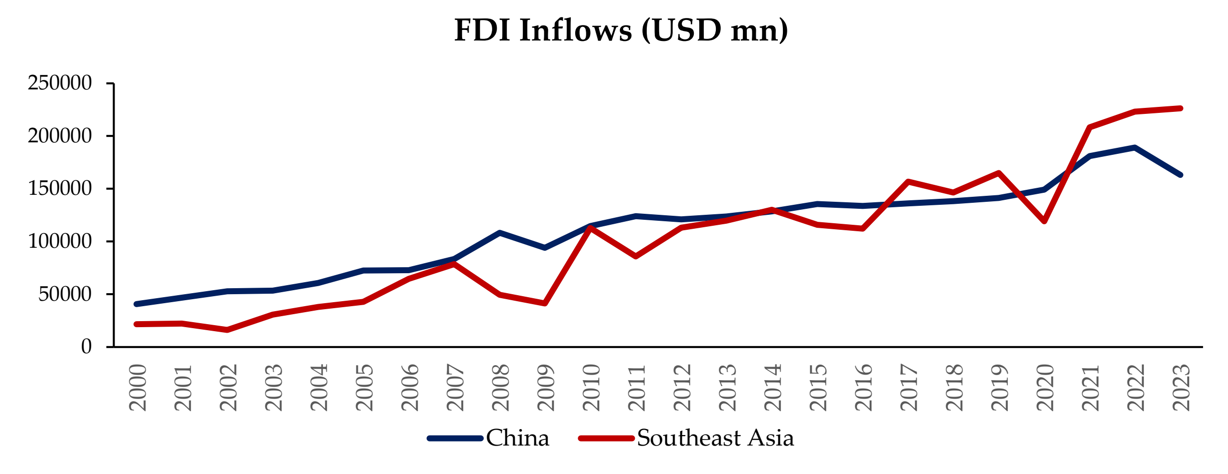
Rising geopolitical tensions between China and the US have resulted in hostile trade measures against China and penalties on companies investing in the country. Southeast Asia, with its relative proximity to China and improvements in its comparative advantages, such as low labour costs and a rising middle-class population, has emerged as a viable alternative to China-centric supply chains. This has resulted in a rise in higher foreign direct investment (FDI) in the region. The November 2023 Asia-Pacific Economic Cooperation summit saw American companies commit over USD 50bn in investments into Asia Pacific markets, with key focus areas including digital connectivity, clean and sustainable energy, cybersecurity, and research capacity[13]. There is little sign that US dominance in Asia-bound investments will diminish; FDI originating from the US into ASEAN grew to USD37bn in 2022, up USD2bn, even as China-origin FDI retreated to USD15bn, down USD2bn. Follow-on action by the new strategic partnerships signed between Washington and several ASEAN capitals will materialize in the coming years, a further tailwind to Asia ex-China.

Companies are also "de-risking" by shifting production out of China, or at the very least, adopting a "China plus-one" strategy to diversify the countries they source inputs from, much to the benefit of Southeast Asia. According to the UNCTAD, the number of greenfield announcements surged by 42% in 2023, adding USD 62bn more in value[14].

- In Thailand, the number of FDI approvals surged by 55% in 2023 with generous consumption and production subsidies playing a crucial role in attracting numerous Chinese EV makers to set up manufacturing capacities in the country.
- Indonesia recorded USD47bn of FDI in 2023, an increase of 13.7%, on the back of strong investments into its mineral processing industry as a result of the export restrictions on unprocessed ores.
- Malaysia successfully persuaded Tesla to locate its regional headquarters and to invest in building the local charging network, providing a boost to both its industrial and energy-transition ambitions. The country's New Industrial Master Plan 2030 is estimated to inject MYR 95bn over the next six years, with a particular focus on EVs.

[13] The White House (November 2023) FACT SHEET: $50B+ of U.S. Private Sector Investments into APEC Economies, as well as Private Sector Contributions to Sustainability, Inclusivity, and Resilience
[14] UN Trade and Development (June 2024) Developing Asia: Large jump in greenfield investment in 2023

FDI inflows to Southeast Asia have overtaken that of China's



Source: UNCTAD World Investment Report 2024

More than its impact on foreign investment, the rising geopolitical tensions will also increase trade in Southeast Asia. A study[15] by the Monetary Authority of Singapore (MAS) to assess the shifts in trade flows in the post-tariff period between 2017 and 2019 showed that in the final electronics goods category, China saw a 6.3 percentage-point decline in its market share of US imports, while Vietnam saw the largest gain in market share of 3.6% points. This is because Vietnam, given its low labour costs and manufacturing capabilities, has benefitted from production relocation away from China. In the intermediate goods space, China witnessed a 17.2 percentage-point reduction in its share of the US import market, while Malaysia saw the largest gains of 7.4% points. Malaysia, traditionally a key producer of intermediate electronics components and accessories, has also seen a surge in foreign investment approvals in the electrical and electronics industry over the past two years. Despite lagging behind more advanced economies in technological capabilities, its openness to FDI, the relative availability of skilled labour, and good transport networks stand out among the ASEAN economies.

The relocation of production hubs and the surge in Asian trade will have downstream impacts, such as stronger investments in ports. The increased demand for shipping capacity is expected to result in the building of new ports or the expansion of existing ones. Singapore is already investing USD15bn into the Tuas Mega Port complex, which when completed in 2040, will be the largest container port in the world. Likewise in 2023 Mediterranean Shipping Company, the world's largest shipper by total capacity, announced a USD 6bn joint venture with the local government of Ho Chi Minh City to build a port there by 2027.

The competition for influence is also boosting aid from China and elsewhere

Not only has heightened Chinese influence affected trade patterns and prompted supply chain reconfigurations, but it has also led countries to support Southeast Asia with security aid to balance the power in the region. An example of this is Japan, which has developed a new 10-year

[15] Monetary Authority of Singapore. (2020). Macroeconomic Review April 2020 Special Feature A: Asia's Electronics Supply Chains and Global Trade Corridors.

plan to improve the maritime capabilities of nations in Southeast Asia that are facing increased encroachment by China into their territorial water.

In late 2022, Japan revised its National Security Strategy (NSS) for the first time in nine years, driven by rising fears about its deteriorating security environment due to growing Chinese economic and military influence. In the new NSS, Tokyo highlights two foreign assistance schemes to promote regional stability through cooperation: a new diplomatic tool, Official Security Assistance (OSA), and its existing international development scheme, Official Development Assistance (ODA).

In FY2023/24, approximately JPY 2bn (USD 15mn) in OSA grants were provided to Bangladesh, Fiji, Malaysia, and the Philippines. The fact that the first recipients of the OSA funding are mostly Southeast Asian states reflects the growing shared threat from China in the region. Moving forward, Tokyo is reportedly planning to expand the OSA in FY2024/25, with potential additions to the list of recipients - including Indonesia, the Philippines, and Vietnam - to maintain its emphasis on the Southeast Asian region.

Efforts to improve infrastructure in the region will attract investments

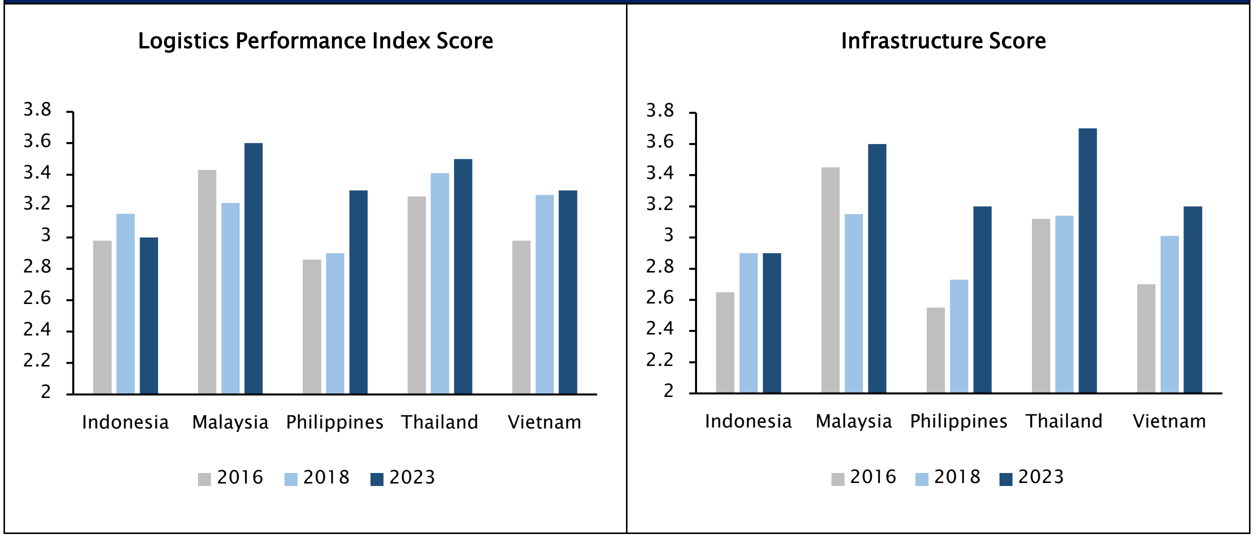
Southeast Asia's efforts to improve its competitiveness extend beyond responding to global geopolitical challenges and China’s weakness. The region has been actively increasing infrastructure spending and supporting infrastructure development, recognizing the substantial economic benefits such improvements bring. Vietnam’s Socio-Economic Development Plan 2021-2030, for instance, highlights infrastructure development as one of the three strategic breakthroughs, while the Philippines estimates a PHP 130tn worth of construction business that will be generated between 2020 and 2030 in a bid to develop infrastructure development by both the public and private sectors. Developed infrastructure not only facilitates the physical mobility of people and goods but also enhances infrastructure and attracts private investment by reducing logistics costs, creating a positive crowding-in effect.

It is not just the quantity of infrastructure that has seen improvement; the quality has also been enhanced. While population growth and rapid urbanization have occasionally compromised infrastructure quality, there have been notable improvements. According to the World Bank Logistics Performance Index[16], the quality of infrastructure in Southeast Asian countries has shown improvement in recent years. This is an encouraging sign, as the quality of infrastructure is as important as the quantity. Infrastructure quality has been positively associated with GDP

[16] The logistics performance (LPI) is the weighted average of the country scores on the six key dimensions:
1) Efficiency of the clearance process (i.e., speed, simplicity and predictability of formalities) by border control agencies, including customs;
2) Quality of trade and transport related infrastructure (e.g., ports, railroads, roads, information technology);
3) Ease of arranging competitively priced shipments;
4) Competence and quality of logistics services (e.g., transport operators, customs brokers);
5) Ability to track and trace consignments;
6) Timeliness of shipments in reaching destination within the scheduled or expected delivery time.

per capita[17] and will serve to attract investors into the region by improving accessibility and ease of travel.

Infrastructure quality has shown improvement over the years



Source: World Bank Logistics Performance Index, Centennial Asia Advisors

Beyond physical infrastructure, the rise in internet connectivity in Southeast Asia presents an opportunity for increased investments in the region. For one, Southeast Asia is rapidly advancing towards a more digital landscape. Smartphone adoption is projected to grow from 84% in 2022 to 93% in 2030, while mobile data traffic per smartphone is expected to surge from 15GB per month in 2022 to 54GB per month by 2028[18]. To effectively meet the needs of consumers, enterprises, and governments (such as cloud ERP and cloud CRM solutions), the region will require more towers and a considerable increase in both local and regional data centres.

Another area of opportunity lies in e-commerce and digital financial services (DFS). With people becoming more tech-savvy and the Covid-19 pandemic forcing many to transition to digital services, the demand for e-commerce and digital financial services has surged. Cash is no longer king, as digital payments now account for 50% of total transaction value[19]. This shift away from cash is expected to continue as digital channels become the dominant means of payment across Southeast Asia. As a result, players in the e-commerce and DFS industries have made inroads into Southeast Asia over the years. Digital banks are leveraging existing merchant and consumer networks to reach unbanked, underbanked populations and young digital natives. Progressive governance has enabled digital financial services (DFS) enterprises like Grab in Singapore, Tokopedia, and GoTo in Indonesia to thrive in the digital finance space. Commercial banks have also launched e-wallets or partnered with DFS enterprises to fast-track their digitalization efforts to capitalize on this trend. This collaborative approach between traditional financial institutions

[17] Deloitte (2020) Infrastructure: Leading Southeast Asia's Economic Recovery
[18] GSMA (2023) The Mobile Economy Asia Pacific 2023
[19] Google, Temasek, Bain (2023) e-Conomy SEA 2023

and digital innovators is essential for expanding access to financial services and driving economic growth in the region.

Southeast Asia boasts of favourable demographics crucial to economic growth

Southeast Asia has the advantage of the demographic dividend expected from the size and growth of its population. In 2022, the combined population of ASEAN reached 671.7mn, maintaining ASEAN's position as the third-most populated region in the world, following India and China. According to the World Population data by the United Nations Population Division, the population of ASEAN will increase from 633mn in 2015 to 717mn in 2030 and 741mn in 2035, at a rate of 0.85% per annum. Southeast Asia's population is not only large and growing but also relatively youthful. The World Bank estimates the working population – including informal workers – at around 350.5 million, of which 60% are below the age of 30. This helps to support the labour market by keeping costs low[20].

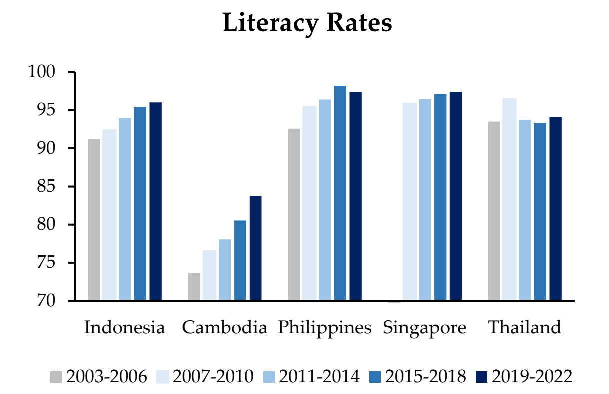
In contrast, China's population is entering a period of decline. Chinese statistics indicate that the total natural population dropped by more than 2mn in 2023. With a fertility rate of 1.0, UN forecasts suggest China's population will dip to 1.3bn by 2050 and further decline to about 800mn by 2100. With a larger, younger, and growing workforce, Southeast Asia holds a comparative advantage over China in terms of labour availability and cost-effectiveness. This demographic edge enhances the region's appeal as a destination for manufacturing, investment, and economic expansion.

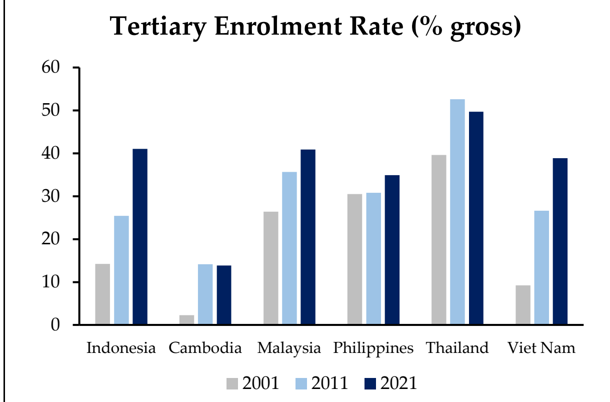
The emergence of a rising middle class, thanks to rapid economic growth, also led to rising urbanization and increasing income levels. Statistics show that the proportion of the middle-class population in Southeast Asia will reach an estimated 50% by 2030, doubling the size of the region's middle-class population from a decade ago. With a growing middle class, consumption patterns will change as the purchasing power of individuals increases, fuelling further consumption growth.

More than just the quantity, the quality of labour in Southeast Asia has improved significantly. Data from the World Bank shows marked improvements in both literacy rates and tertiary enrolment rates over the past two decades. These advancements highlight the region's potential to sustain long-term economic growth. As the workforce becomes more educated and skilled, Southeast Asia is better positioned to move up the value chain, attract higher-value industries, and drive innovation. This progress not only enhances productivity but also boosts the region's competitiveness in the global market, paving the way for sustained economic development.

[20] Data retrieved from World Bank Open Database

Quality of human capital has risen through the years



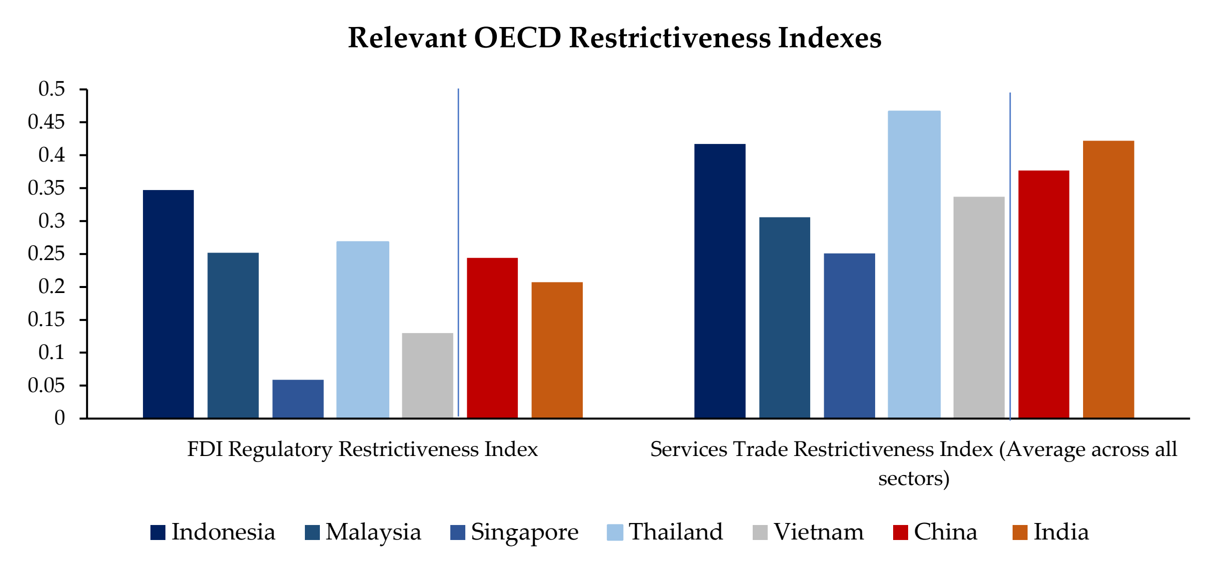


Source: World Bank

Southeast Asia has been increasingly open to reforms to drive investments

In 2022, foreign direct investment (FDI) inflows into ASEAN reached an all-time high of USD 224bn. This increase came at a time when global FDI flows saw a 12% decline due to the multitude of international crises and challenges, such as geopolitical conflicts, high inflationary environment, and mounting debt pressures, highlighting the resilience of ASEAN nations. The surge in FDI did not happen overnight; it is the result of sustained efforts by governments across Southeast Asia to reform their economies and make them more attractive to investors, such as by providing incentives to attract FDI, liberalizing FDI policies, and implementing institutional reforms. As seen in the chart below, some Southeast Asian economies, namely Singapore, Vietnam, and Malaysia, fare well compared to other non-OECD nations such as China and India.

Southeast Asia fares well in loosening trade and investment restrictiveness



Source: OECD Services Trade Restrictiveness Index. OECD FDI Regulatory Restrictiveness Index

Table 1: Southeast Asia has taken steps to attract FDI in the region

Category	Description
FDI Liberalization	• Indonesia's Positive Investment List allows foreign investors to fully own a business in over 200 business sectors, including transportation, energy, and telecommunication. • The Philippines in 2022 promulgated the Philippines' Twelfth Regular Foreign Investment Negative List (RFINL) to update regulations and specifications governing foreign investment. An example is the removal of restrictions on the manufacture and distribution of products requiring clearance from the Defense Department, which were previously limited to 40% foreign equity.
Tax and Investment Incentives	• Cambodia enacted a Law on Investment that incentivizes investment in 19 sectors, including high-tech industries and projects targeting innovation, research and development, digital infrastructure and high value-added manufacturing. • Thailand will allow companies or juristic partnerships to deduct expenses from purchasing e-bus and e-truck from their corporate income tax (CIT) liability to spur its electric vehicles (EV) sector. • In the Philippines, the enactment of the Corporate Recovery and Tax Incentives for Enterprises (CREATE) Act in 2021 grants private enterprises over PHP 1tn in tax relief over the next decade, lowering the financial burden faced by foreign and domestic companies.
Legal and Institutional Reforms	• Cambodia updated its Law on Investment to streamline administrative processes and introduced the "Cambodia My 2nd Home" visa programme targeting foreign investors with investment capital of at least USD100,000 who own real estate in the country. • In December 2021, the Thai Revenue Department extended the deadline for country-by-country taxation reports from 150 days to 12 months, aligning with OECD guidance and reducing administrative burdens for businesses.
Labour reforms	• In January 2024, Thailand's Eastern Economic Corridor (EEC) issued a new investor visa to boost foreign investments in targeted industries. Companies in these industries will receive a new investor visa with a maximum duration of 10 years. In addition, these visa holders will have an automatic issuance of the EEC work permit, be eligible for a 17% flat income tax rate, and have a dedicated fast-track channel at international airports in Thailand. • In September 2023, Indonesia announced that it is introducing a 'golden visa' program to allow foreign investors to receive a resident permit of between five and 10 years, depending on the value of their investment.

Source: ASEAN Briefing, Associate of Southeast Asian Nations 'ASEAN Investment Report 2023', Centennial Asia Advisors

Cooperative frameworks within Southeast Asia will enhance trade and connectivity

Given the current geopolitical trends, Southeast Asian economies will look to protect themselves against the economic fallout of US-China competition and maintain flexibility amidst a shifting global economic architecture. This will not be an easy task; the pre-existing trade patterns were developed over decades and any restructuring will entail significant dislocations to firms and industries, who will have to adjust their business models and supply chains. However, governments in the region do have cards to play, and we envision that the following strategies, already in play to some extent, will continue to develop in the coming years.

First, the region's network of free trade arrangements is likely to serve the region well, and governments will be seeking to further expand their coverage and depth so that they can leverage each other's product and consumer markets. Among other initiatives, the Regional Comprehensive Economic Partnership (RCEP), which is in its early years of coming into effect, provides a channel by which participating countries can at least partially offset losses under an environment of heavy decoupling activity. These also allow some Asian markets to take advantage of anti-China protectionism by occupying the space that Chinese exports have previously occupied, with Vietnam, Malaysia, and Indonesia seen as having made gains in global market shares in sectors where Chinese exports have lost ground.[21] Also worth noting is the ongoing negotiations to upgrade the ASEAN-China Free Trade Agreement, which we see as part of efforts for the bloc to act as a "meeting point" market between the US- and China-led blocs.

Second, synergies from regional cooperation frameworks have enhanced economic integration and promote growth for the region. The Greater Mekong Sub-Region (GMS) – which covers Cambodia, the People's Republic of China [Yunnan Province], the Lao People's Democratic Republic [Lao PDR], Myanmar, Thailand, and Vietnam – is an example of a successful regional integration. Since the launch of the economic integration in 1992, growth in the region has averaged close to 8% per year, with growth in most countries being even more rapid in the second decade of the agreement than in the first. The benefits of the cooperation have been multifold: High growth in the GMS has helped greatly in reducing overall poverty levels. In 1992, all countries in the region except Thailand had poverty levels (based on a cut-off point of USD1.25 per day) close to or higher than 50%. However, by 2011, the poverty incidence had been dramatically reduced in Cambodia, PRC, Lao PDR, Thailand, and Viet Nam. The strong growth performance has also resulted in large increases in per capita incomes throughout the region, as seen in the tables below.

Table 2: The Greater Mekong Sub-Region's impact on participating countries

	Per capita GDP (Current, $)		Poverty Incidence (%)	
	1992	2022	Earliest	Latest
Cambodia	270	1,760	47.0	17.8 (2019)
PRC	268	12,720	6.0	0.1% (2022)
Lao PDR	278	2,054	45.0	23.1 (2021)
Myanmar	63	1,149	32.1	24.8 (2017)
Thailand	1,894	6,910	28.4	5.4 (2022)
Vietnam	444	4,163	58.1	4.2 (2022)

Source: Asian Development Bank, CEIC, Centennial Asia Advisors

In recent years, other countries in the region are also exploring more opportunities for regional cooperation. For instance, in January 2024, the governments of Malaysia and Singapore inked a memorandum of understanding that formalizes the proposal for a Special Economic Zone between the city-state and Malaysia's southern state of Johor. While, at the point of writing, the precise parameters of the proposed zone are subject to further negotiations between the two sides,

[21] Zhao and Ho (2023) *Has the Shifting Trade Landscape Changed the China–ASEAN Nexus?*

the preliminary measures already agreed upon show substantial promise. The memorandum of understanding envisions further initiatives to smoothen frictions for the movement of goods, services, and people across the bilateral border, such as via a passport-free QR code-based system for immigration clearance and a digitized cargo clearance process at land checkpoints. This follows from earlier agreements to increase the frequency of cross-border rail and ferry services, as well as unilateral moves by both sides to improve immigration at their respective borders, which will go some distance in resolving the immediate pain point facing businesses seeking to exploit cross-border opportunities. Other preliminary measures such as joint marketing of investment and trade, and bilateral business consultations, also pave the way for opening up business linkages that will be crucial for the zone's success. These initiatives will not only drive growth locally, but will catalyse economic cooperation and interconnectivity between two of Southeast Asia's most prosperous economies.

Related to the above is an ongoing effort to "reindustrialize" Asian economies. Many economies in the region have faced the phenomenon of premature deindustrialization, which has partially been pinned on them losing their industrial base in the face of competition from cheaper Chinese exports in the aftermath of its accession to the World Trade Organization. The fragmentation of value chains away from China-centric arrangements opens up opportunities for other Asian markets to stake new positions in global value chains, potentially reversing premature deindustrialization if this process takes shape. Governments in the region are thus pursuing various forms of industrial policy, either in terms of support for specific sectors (the semiconductor and vehicle sectors stand out as two prominent examples), or broader structural reforms such as regulatory easing, economic zones, and other forms of support such as production or relocation subsidies.[22]

In addition to reindustrialization efforts, we also anticipate that the region will seek to take advantage of new forms of trade diversification, particularly in the services and digital sectors. Once again, Asia has many advantages that place it favourably in this market; fairly-well-educated labour markets that still have affordable wages, good levels of English language proficiency, and high digital connectivity make emerging markets in the region ideal hubs for digitally-deliverable services such as office support services, consulting, and other professional services. The new wave of trade agreements, including RCEP and the CPTPP has a welcome emphasis on these markets, and countries themselves are seeking to bolster their position via domestic or trade policy initiatives; Singapore, for instance, has placed much emphasis on its "Digital Economy Agreements", which include clauses to facilitate cross-border business activity in emerging technology sectors including artificial intelligence, data governance and innovation, and digital financial services.

Conclusion

None of this is to say that this process will be an easy one given the scale of the potential shifts in world economics and geopolitics. However, we remain optimistic that most of the region has the

[22] Qureshi and Lanzafame (2023) *Industrial Policy Is Back: What Does It Mean for Asia and The Pacific?*

required ingredients to successfully manage the risks of their existing trade structures while managing the transition to new, improved positions in the global economy in the long run.

The Emerging Markets Forum was created by the Centennial Group as a not-for-profit initiative to bring together high-level government and corporate leaders from around the world to engage in dialogue on the key economic, financial and social issues facing emerging market countries.

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http://www.emergingmarketsforum.org
2522A Virginia Avenue NW, Washington, DC 20037, USA.
Tel:(1) 202 393 6663 Fax: (1) 202 393 6556
@EmrgMktsForum
Email: info@emergingmarketsforum.org

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