Asia Pacific Economic Forecast

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Malaysia may not perform as robustly this year as in the past few years. Its Q2 GDP growth was the slowest since the global financial crisis hit the economy in 2009, and macroeconomic fundamentals are under stress. In such a scenario, will the central bank step in with measures to help the economy maintain growth? More importantly, can such measures mitigate the effect of external factors pushing down growth?

Malaysia

Struggling to get out of the loop

By Dr. Rumki Majumdar

MALAYSIA'S economic growth is moderating. The outlook is muddled by political and global factors, and strong economic performance seems unlikely this year despite resilient domestic demand. While the Bank Negara Malaysia (BNM) announced an unexpected rate cut in July to support consumer spending and investment, it may decide not to ease monetary policy further for the rest of the year to contain risks emerging from highly leveraged households and capital outflows.

Macroeconomic fundamentals under stress

In Q2 2016, GDP increased at the slowest pace since the global financial crisis hit the economy in 2009. Annual growth slipped to 4.0 percent in Q2, extending the trend of slowing growth to five straight quarters. Net exports and the agricultural sector continued to be a drag on growth, although a sharp run-down in inventories also contributed.

Domestic demand continued to remain resilient, and grew 4.9 percent year over year. Private consumption grew 6.4 percent in Q2 due to continued income growth and a government stimulus program for low-wage employees. The growth in consumption was primarily driven by spending on food and beverages, transportation, and communication. Fixed investment growth saw a sharp jump in Q2, from 0.1 percent in Q1 to 6.1 percent in Q2, the fastest increase in the past five quarters. Growth was primarily driven by a strong revival in machinery and equipment investment. Both public and private sectors registered strong investment growth, with public spending contributing the most to growth in Q2. That said, growth in investment has remained highly vulnerable since late 2014.

The external sector continued to remain a worry as net exports of goods and services contracted for the second consecutive quarter. Exports recovered marginally and grew 1.0 percent in Q2. However, global uncertainties and weak demand continued to weigh on trade prospects. Right now, the current account surplus is at record low levels. Net exports are expected to remain a drag on growth this year, as sluggish global trade will limit export opportunities.

The other worry is that of rising fiscal deficit as the government boosts spending to prop up growth. The government has been spending robustly on infrastructure, while revenues from corporate taxes, goods and services taxes (GST), and oil continue to disappoint. Over the past year, both government consumption and investment have increased significantly to support growth. In addition, the government will likely have to take responsibility for the debt held by the state-owned 1Malaysia Development Bhd. (1MDB), which defaulted on a $1.75 billion bond. A part of the borrowed sum is guaranteed by the Malaysian government, and repayment of the debt will likely increase the risk of fiscal slippage this year. The fiscal deficit may widen and could be 0.5 percentage points higher than the projected deficit of 3.1 percent.

One more risk is that of high household debt, which may weigh on future consumption spending. The household debt-to-GDP ratio has increased by 1.5 times between 2008 and 2014, from 60.4 percent to 89.9 percent. Favorable credit conditions reinforcing high consumer demand led to a ballooning of household debt during this period. On the other hand, financial assets to total household debt have been falling steadily. Non-performing and impaired loans for personal use increased by over 32.0 percent year over year, while for credit cards, they increased by over 7.0 percent year over year in July 2016. All this indicates that overleveraged households are at risk and may pose a threat to growth.

The external sector continued to remain a worry as net exports of goods and services contracted for the second consecutive quarter.

However, there is a silver lining to the data. The industrial production index jumped 5.3 percent year over year in June, which is the fastest growth rate since July 2015. The growth was fairly broad based, which suggests the economy remains resilient. At the same time, the consumer price index fell to a 16-month low in July.

Monetary policy to the rescue

Emerging risks, such as a weaker external position due to lower oil prices and weakened global trade, excessive leverage of key sectors, and pressure on public finance are impacting the economic outlook for Malaysia. In addition, external factors such as China's slowdown, poor demand growth in advanced countries, volatile capital flows, a potential Fed rate hike, and Brexit are also adding to the uncertainty. The economy needs policy initiatives to counter the repercussions of external headwinds.

However, there is limited room for the government to act in order to boost the economy, as it may fail to meet its deficit target as budgeted for the year. With the expectation that the government may keep a tight rein on spending, the central bank may try to step in through monetary policy easing to revive growth prospects. In fact, BNM surprised the market when it announced a rate cut in July for the first time in seven years in a bid to keep the country on a "steady growth path." Low inflation rates and a relatively strong currency also helped the BNM to ease monetary policy.

Emerging risks, such as a weaker external position due to lower oil prices and weakened global trade, excessive leverage of key sectors, and pressure on public finance are impacting the economic outlook for Malaysia.

The interest rate cut by BNM in July is likely to provide some support for private investment and household spending. That said, the BNM will remain cautious about providing additional stimulus to the economy this year, as it may result in excessive leveraging in the highly indebted household sector. Besides, too much easing might give the wrong signal to investors and increase the risk of capital outflows.


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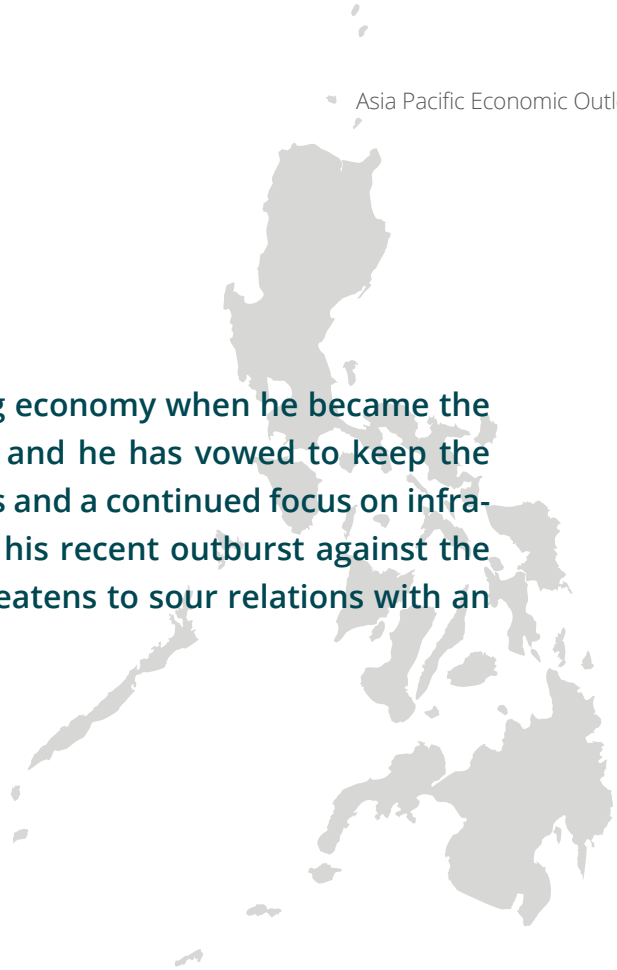


Rodrigo Duterte inherited a strong economy when he became the 16th president of the Philippines, and he has vowed to keep the momentum going with tax reforms and a continued focus on infrastructure development. However, his recent outburst against the president of the United States threatens to sour relations with an important ally.

The Philippines

But for some harsh words, it's going well

By Akrur Barua

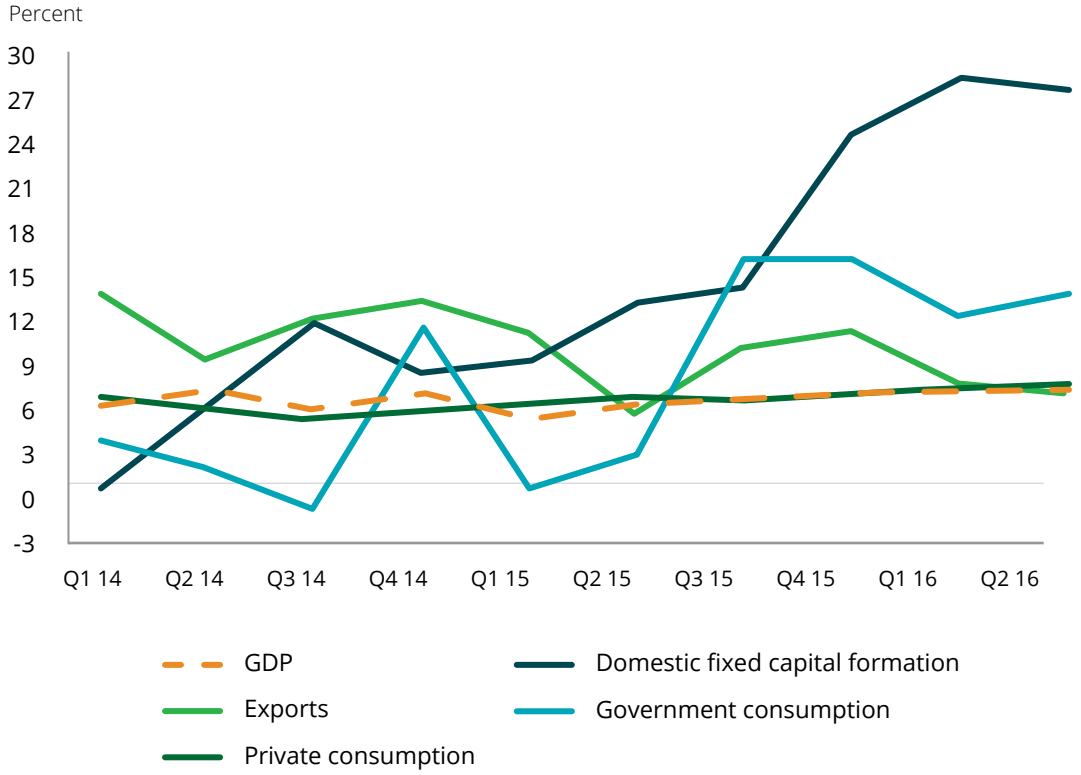
A STRONG economy is every elected leader's dream as he or she inherits office. Rodrigo Duterte couldn't have asked for more when he took over as the 16th president of the Philippines in June.[1] The economy has been performing well for the past few years, much better than some of the country's more illustrious neighbors. In fact, August brought in fresh cheer as the Philippines Statistics Authority announced that the economy expanded at one of the fastest rates in Asia in Q2. The new president has pledged to keep the momentum going by reforming the taxation regime, making it easier to do business, and continuing with his predecessor's focus on infrastructure development. What would help the president a bit more, however, is perhaps a little more diplomacy as he tries to maneuver his way through international relations with high economic and political stakes.

A good economy to inherit

The economy grew by 7.0 percent year over year in Q2, the fastest pace since Q2 2013. Consumer spending continued to shine in Q2, growing 7.3 percent. Low inflation, upbeat sentiment, low unemployment, and strong remittances have augmented consumer spending. Remittances from overseas Filipinos, which amounts to 9.0 percent of GDP (2015), grew 4.1 percent in the first half of this year.

Private investment continues to be strong; so does government spending (figure 1). The lone worry is export growth, which slowed for the second straight quarter. Merchandise exports, in particular, have been under pressure, declining for the 16th straight month in July. Services exports, however, continue to rise, aided by the expanding business process outsourcing sector.

Figure 1. Investments, government spending, and consumers kept economic growth strong in Q2



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Price pressures remain benign amid easy credit conditions. In August, inflation fell to 1.8 percent from 1.9 percent in July. Inflation is likely to remain within the Bangko Sentral ng Pilipinas' (BSP's) 2.0–4.0 percent target corridor this year. With an able central bank chief who has presided over the global financial crisis of 2008–09 and the current bout of domestic economic growth, President Duterte can draw comfort from the strong stewardship of monetary policy.

Starting with the right agenda: Tax reforms

For those initially nervous about President Duterte's economic agenda, the first two months in power have been reassuring. Both the president's first State of the Nation Address and his economic team's 10-point agenda give glimpses of a strong reform agenda, especially tax reforms.[2]

First, the government wants to change the income brackets for direct income taxes.[3] These brackets were framed about two decades ago. A rise in the exemption limit—logical due to inflation over the years—will benefit low- and middle-income households. Any form of inflation indexing will be even better. Second, in a bid to boost tax payment the government is eager to reduce the highest rate of income tax from 32.0 percent to 25.0 percent.[4] This will also help those whose nominal incomes fall in the top tax bracket, one that was decided nearly 20 years ago. These measures will also boost consumer spending in the medium term.

To offset possible losses in income taxes, the government will likely raise taxes on luxury goods and non-essential items like tobacco. A hike in the excise duty on oil products is also likely. The government

is seeking suggestions on whether to raise the value added tax rate and cut down exemptions, although there is yet no clarity on this.[5] It has also hinted at reducing tax incentives for foreign investors, a move that may add to the discomfort of foreign companies having to comply with red tape and poor infrastructure compared to other parts of Asia.[6] However, the government contends that any reduction in tax incentives will be accompanied by the easing of business conditions to offset costs for foreign investors. The government is also planning to cut down corporate tax from 30.0 percent to 25.0 percent, a move likely to aid private investments.[7]

Higher spending and changes in the tax regime will have an immediate impact on the fiscal deficit, which was 0.9 percent of GDP in 2015. Already, the government has said that the deficit will rise to 2.5 percent this year as it aims to ramp up spending on infrastructure and social welfare.[8] However, any sharp spike in fiscal deficit beyond the revised target will invite unwanted scrutiny from rating agencies under whom the country got its first investment grade rating last year. To meet its strong spending targets on infrastructure and social welfare—26.3 percent of the people still live below the poverty line—the government will have to expand the tax base, which is woefully small, especially among the self-employed.[9] Not only will that take care of funds for development, it will also ensure that the fiscal gains of the past few years will continue.

A careful choice of words, perhaps?

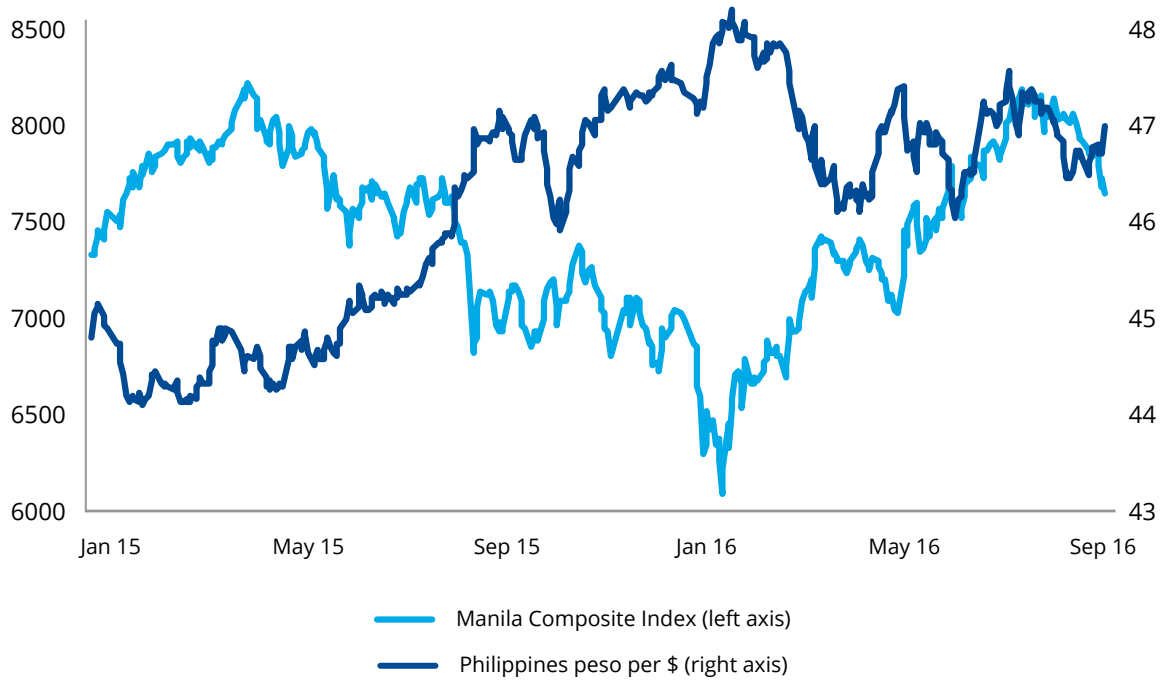
President Duterte, however, has a long way to go in global diplomacy. His recent outburst against the president of the United States threatens to sour relations with an important ally. The United States has close military ties with the Philippines and, in 2014, signed a 10-year military deal.[10] US support will also be crucial in any talks with China over an International Court of Justice ruling that supports the Philippines' claims against China's in the South China Sea.[11] Economically too, the Philippines has much to gain from the United States. The latter is the largest source of foreign direct investment in the Philippines—about $0.7 billion out of a total of $5.7 billion in 2015—and its role is vital in the Philippines' efforts to join the Trans-Pacific Partnership trade bloc.[12]

President Duterte's harsh words on military relations with the United States and his recent overtures to China may be an effort to draw benefits from both countries But, it is a fine line that he is treading and is not likely to bring in immediate benefits.

President Duterte's harsh words on military relations with the United States and his recent overtures to China may be an effort to draw benefits from both countries.[13] But, it is a fine line that he is treading and is not likely to bring in immediate benefits. Increasing rhetoric against other countries and the United Nations will also not mitigate concerns about President Duterte's war on drugs, which has resulted in more than 3,000 deaths over three months.[14] Although the logic behind his clampdown on drugs is accepted—about 1.7 million people in the country are addicted to illegal substances—the method behind the surge in killings is unnerving many in the global community.[15] Surely, any outbursts alone will not stop such concerns being expressed occasionally by leading nations.

Things could, in fact, turn worse for the Philippines if the country loses out on the economic and political goodwill it has gained over the years. President Obama, for example, cancelled his meeting with President Duterte after the latter's outburst. And there are early signs that the economy could be impacted in the absence of better diplomacy as foreign inflows slow down and the stock market sheds some of its gains this year (figure 2).[16] The Philippines needs all the global help it can get to continue the economic momentum of the past few years and to improve infrastructure and regulations. Loopholes

Figure 2. Stock prices have eased of late and the peso is down



Source: Haver Analytics, Deloitte services LP economic research.

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in the latter were evident during the $81 million cyber heist at Bangladesh's central bank, in which part of the stolen money was routed through the Philippines.[17]

While acting the strongman may play well for President Duterte at home, reconciling differences in geopolitics will be a far tougher task. The world, especially foreign investors, will be watching closely.

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A revival of overseas demand, especially from China and Hong Kong, as well as an increase in exports to Europe, helped Taiwan's GDP grow in the second quarter, after three consecutive quarters of decline. However, what to expect in the longer term is of greater importance, and the good news is that the signs are positive.

Taiwan

GDP grows on a rebound in exports

By Ira Kalish

AFTER declining for three consecutive quarters, Taiwan's real GDP finally grew in the second quarter of 2016. Growth was largely attributable to a rebound in exports. That, in turn, followed a long period in which the value of the currency declined, thereby improving export competitiveness. Moreover, second quarter export growth benefitted from a revival of overseas demand, especially in China and Hong Kong. Exports to Europe revived as well. On the other hand, consumer spending grew only modestly and business investment continued to decline in the second quarter. Of greater importance than second quarter performance, however, is what to expect in the third quarter and beyond. The good news is that there are a number of positive signs.

First, exports grew in both July and August in dollar terms, boding well for further export growth in the third quarter. Moreover, the rebound in exports is likely to spur a recovery in business investment in order to meet rising overseas demand. Plus, expected strong demand for the next generation of consumer electronics is likely to boost both investment and exports in Taiwan, a country that produces many of the electronic inputs used in smart phones and other products. On the domestic side, employment has begun to increase after decelerating significantly in 2015 and early 2016. This should help boost the consumer side of the economy.

Second, improving economic strength has likely been fueled by an easier monetary policy. The central bank has cut its benchmark interest rate four times since late 2015. This was made possible by the fact that inflation remains quite low. Prices actually fell significantly in 2015 as the drop in oil prices took a toll. Yet inflation made a comeback in 2016, running currently at about 1.0 percent per year. In addition, the currency, having fallen sharply from 2013

to 2015, has risen since early in 2016, putting downward pressure on inflation. This provided room for the central bank to cut rates with impunity. However, it is likely that the Taiwanese currency will fall again if and when the US Federal Reserve tightens monetary policy.

The bottom line is that the Taiwanese economy should continue to grow modestly in the second half of 2016 and accelerate modestly in 2017. Inflation is expected to remain low and monetary policy can be expected to remain accommodating. Much, of course, will depend on China, Taiwan's most important trading partner. If the Chinese economy stabilizes, as seems likely at the moment, this will be to the benefit of Taiwan.

In terms of risks to the Taiwanese economy, they are minimal. Taiwan benefits from the fact that it has a modest government budget surplus, thus providing sufficient wiggle room to stimulate the economy in the event of a downturn. In addition, Taiwan has a very large external surplus, more than 13 percent of GDP, thus significantly reducing the risk that a downturn in trade or cross-border capital flows might lead to significant currency movements, capital flight, or inadequate liquidity for the financial system. An external surplus actually means that a country is exporting capital, often to support its own exports of goods and services. It reflects an excess of saving over domestic investment. Another positive factor for Taiwan is the fact that both unemployment and inflation are low, thus enabling the central bank to focus on the currency and on the country's competitiveness. Thus, from a policy perspective, Taiwan is well positioned to absorb future shocks.

On the downside, Taiwan's demographics, like those of other affluent countries, are worsening due to a low birth rate and a paucity of immigration. The working age population has already begun to decline, thus ensuring slower economic growth in the absence of accelerated productivity growth. Moreover, Taiwan faces increased competition from China. The latter is moving up the value chain, investing in processes that used to be done in places like Taiwan. Now, there is increasing vertical integration in China. Thus, Taiwan will have to focus more on final markets in the future (such as Europe, the United States, and Southeast Asia), rather than relying on providing inputs for final producers in China. Taiwan's competitiveness, therefore, will depend on having high-quality human capital at a reasonable cost. It will also depend on developing more competitive service industries and not simply relying on manufacturing. Indeed the future development of world class service industries is likely to be the best path toward faster productivity growth.

The bottom line is that the Taiwanese economy should continue to grow modestly in the second half of 2016 and accelerate modestly in 2017.

Vietnam has set its sights on becoming an upper-middle-income economy by 2035. To achieve this, it needs to ensure rapid growth, bolstered by innovative reforms, some of which have already been undertaken. However, sluggish reforms, a complicated external environment, and the lull in growth pose challenges.

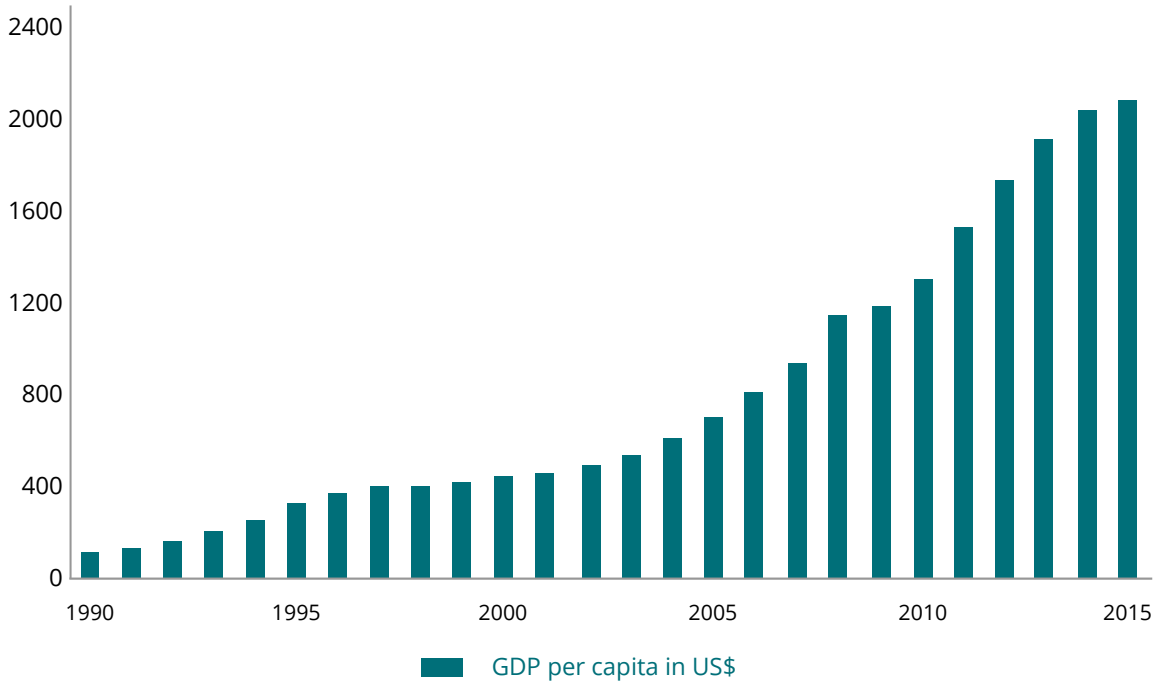
Vietnam

Aiming high despite challenges

By Lester Gunnion

AFTER almost a decade of quick growth, emerging market economies (EME) have experienced below-trend growth since the end of the global financial crisis in 2009. Factors such as a slowdown in China, depressed commodity prices, tepid demand in developed economies, elevated levels of household and corporate debt, and the normalization of US monetary policy are likely to keep the lid on EME growth in the near term. However, despite the broad slowdown, there have been pockets of quick growth—in Asia; Vietnam stands out, having recorded the second fastest rate of growth in 2015, behind India. The "Doi Moi" market reforms initiated in Vietnam 30 years ago (1986), allowed the economy to propel itself from low-income status in 1990 to lower-middle-income status in 2015 (figure 1). Growth during this period was dominated by the inflow of foreign investment. Lower labor costs relative to China have also lured manufacturers to shift base to Vietnam in recent years. At present, with foreign investment continuing to flow into the economy, Vietnam has set its sights on becoming an upper-middle-income economy by 2035. To achieve this long-term goal, rapid growth will need to be bolstered by a fresh new spurt of innovative reform in the near to medium term. Indeed, measures to reform the Vietnamese economy have already been undertaken, partly under compulsion, due to participation in the proposed Trans-Pacific Partnership (TPP). However, the sluggish pace of reform, a complicated external environment, and the current lull in the rate of growth pose challenges to Vietnam's future growth trajectory.

Figure 1. Vietnam, GDP per capita in US$, 1990 to 2015



Source: General Statistics Office of Vietnam/Haver Analytics, Deloitte Services LP economic analysis.

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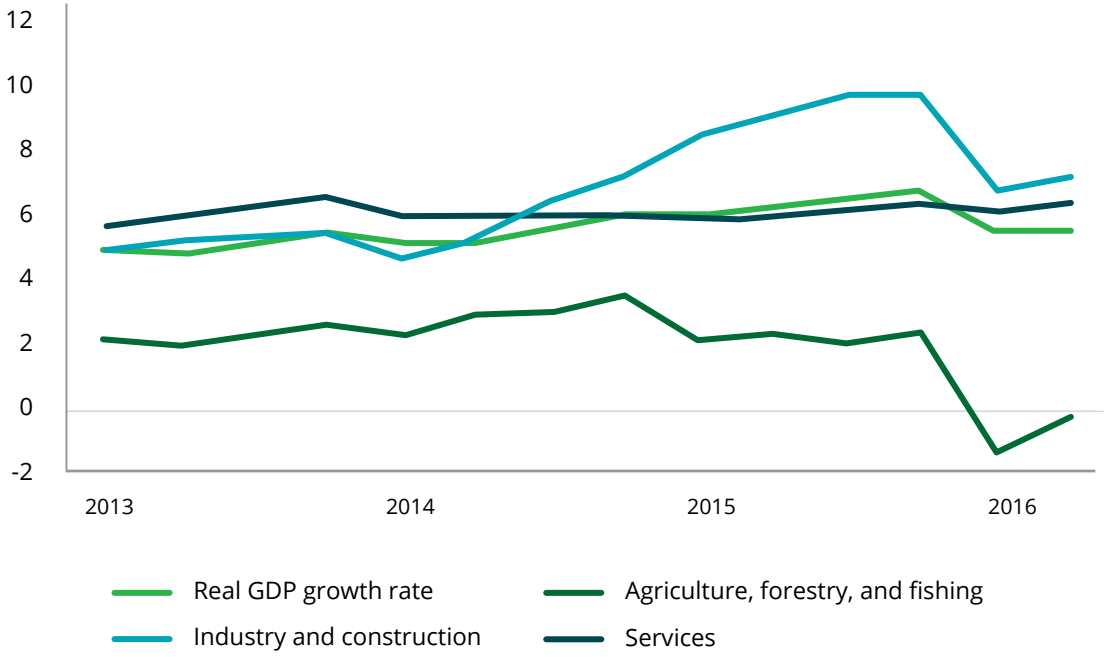
Growth dips in the first half of 2016 due to drought and slower gains in industry

Growth in real GDP moderated to 5.5 percent in the first half of 2016 from an annual growth rate of 6.7 percent in 2015 (figure 2).[1] A persistent El Nino-fueled drought, one of the most severe over the span of a century, has affected agricultural production in the country's fertile Mekong Delta. Lack of rain and salinification from sea intrusion have had an adverse effect on the agriculture, forestry, and fishery sector in 2016—the sector, dominated by agriculture, declined 0.2 percent in the first half of the year. Agriculture alone shrank by 0.8 percent in the first half of 2016 relative to the same period a year ago.[2] Even though the primary sector accounts for just 16 percent of GDP, it employs nearly half of Vietnam's workforce. Furthermore, the drought has also reignited discussion over China's hydroelectric dams across the head of the river Mekong, which affect the flow of water to Laos, Cambodia, and Vietnam in the south. Internally too, a rapid increase in the number of wells in the Mekong delta and a labyrinth of agricultural infrastructure built due to

A persistent El Nino-fueled drought, one of the most severe over the span of a century, has affected agricultural production in the country's fertile Mekong Delta. Lack of rain and salinification from sea intrusion have had an adverse effect on the agriculture, forestry, and fishery sector in 2016.

Figure 2. Vietnam, Real GDP growth by industry %, year over year



Source: General Statistics Office of Vietnam/Haver Analytics, Deloitte Services LP economic analysis.

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policy that supports intensive production of rice (a water-thirsty crop) is proving burdensome.

The industry and construction sector also slowed in the first half of 2016, growing 7.1 percent from the same period a year ago compared to annual growth of 9.6 percent in 2015.[3] Part of the slowdown is due to base effect. However, industry growth was mitigated by a dip in mining and quarrying due to low commodity prices, particularly of crude oil. The moderation in industry growth is despite robust gains in the manufacturing sector (10.1 percent in the first half of 2016). Construction grew a healthy 8.8 percent in the first half of the year, but gains were below the annual growth rate of 10.8 percent in 2015.[4]

The services sector was a bright spot in the first half of the year—it grew 6.4 percent relative to the same period last year, marginally faster than the annual growth rate of 6.3 percent in 2015.[5] Wholesale and retail, finance and banking, boarding and lodging, and real estate recorded healthy growth. This reflects the healthy domestic demand, quick credit growth, influx of tourists, and the liberalization of the real estate sector.

From an expenditure-on-GDP perspective, consumption grew a healthy 7.0 percent in the first half of the year and gross capital formation increased by 10.0 percent. However, net exports subtracted from overall growth in GDP. Vietnam's trade deficit in services exceeded its trade surplus in goods, reflecting continued dependence on the import of trade-related services, particularly of transportation services.

Quick growth and further reform is what Vietnam requires for future success

According to a joint report by the government of Vietnam and the World Bank Group, Vietnam needs to grow at an annual rate of at least 7.0 percent over the next 20 years in order to fulfill its ambitions of becoming an upper-middle-income country by 2035.[7] However, achieving this long-term goal re-

quires the hastening of reforms. The report identifies six key transformations that are required—building modern institutions, enabling private sector-led economic modernization, developing innovation capacity, promotion of social inclusion, managing efficient urbanization, and achieving sustainable and climate-resilient growth.[8] Furthermore, the joint report forecasts that Vietnam would achieve only two-thirds of its GDP per capita growth target over the next two decades if reforms are not fully implemented.[9]

At present, certain reforms are underway. These include the privatization of Vietnam's large state-owned enterprises (SOEs), consolidation and reform in the banking sector, liberalization of the real estate sector, and reforms in the labor market. However, the pace of reform is a cause for concern. For instance, Vietnam is behind its target for privatizing SOEs—the government targeted 289 SOEs in 2015 but managed to privatize only 182.[10] Moreover, mostly small stakes were offloaded without affecting management control.

> The government's bid to maintain fiscal prudence could result in a slowdown of investment in much-needed infrastructure.

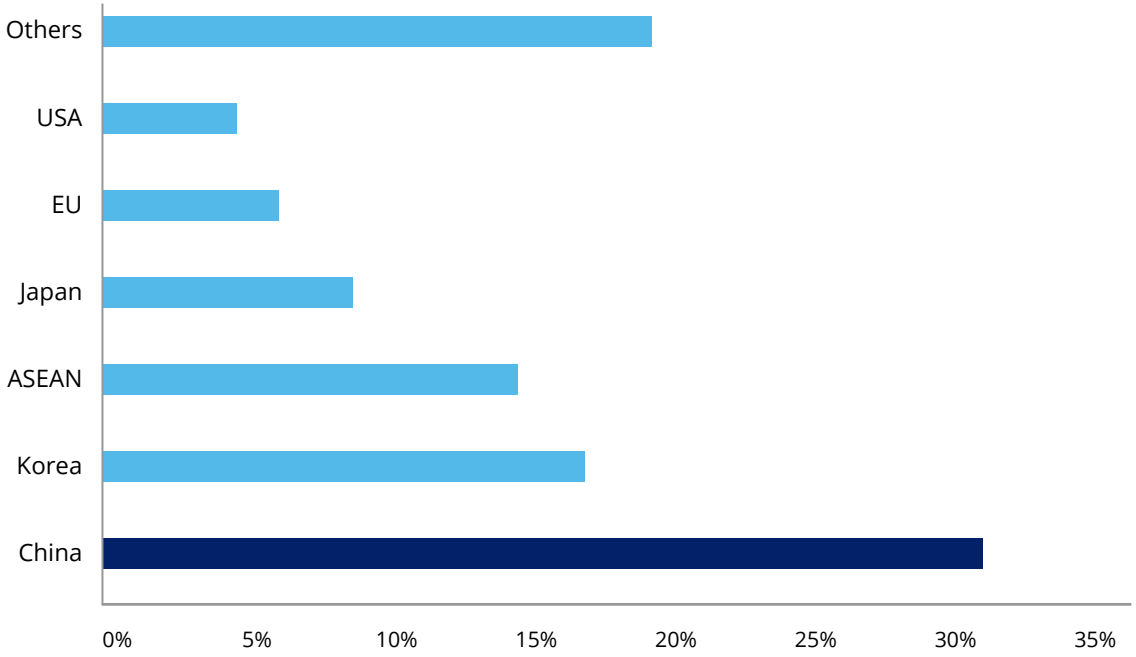
Similarly, in the banking sector, consolidation targets are unlikely to be achieved on time. The World Bank noted in a report in April 2016 that reducing the number of commercial banks in Vietnam to the targeted 15, from the current 34 by 2017 would be difficult.[11] Furthermore, even though the non-performing loan ratio in the banking sector has been reduced to less than 3.0 percent, much of the bad debt has merely been transferred to the Vietnam Asset Management Company (VAMC). The VAMC, however, lacks a well-defined strategy to sell the bad debt it has undertaken. Additionally, private sector credit grew rapidly in 2015 (17.3 percent), and a growth rate of 18.0 to 20.0 percent is targeted in 2016.[12] However, quick credit creation coupled with the easing of ownership rules for foreign investors in Vietnam's real estate sector could raise the specter of the 2011–12 real estate credit bubble. Finally, the push toward labor market reforms, such as allowing the formation of independent trade unions run the risk of being token efforts toward meeting the requirements of the Trans-Pacific Partnership (TPP) if trade union links to the Vietnam Confederation of Labor continue to stay in place.

Uncertainty surrounding the TPP and internal problems will pose a challenge

While Vietnam works toward meeting the requirements of the TPP, the risk that the deal will not be ratified by the US Congress has risen. The final realization of the TPP remains closely linked to the outcome of the US presidential elections. Both presidential candidates have offered resistance to the TPP at this stage. This is significant for Vietnam, especially since it is likely to be the foremost beneficiary of the trade deal. Nonetheless, if the TPP is ratified by the United Sates, it would likely signify Vietnam's shift away from China's ambit of influence in terms of trade (figure 3). This would likely hasten backward linkage investments into the country from China and South Korea, Vietnam's main sources of imports, primarily in the textiles, garments, and footwear sector. The TPP therefore takes on added significance for Vietnam, not least because of its dependence on China for imports and the recent territorial dispute between the two nations in the South China Sea (East Sea in Vietnam).

In addition to these external uncertainties, Vietnam has internal problems to address. The fiscal deficit stood at 5.9 percent of GDP in 2015, having grown over the years due to expansionary fiscal policy in the wake of the global financial crisis.[13] At present, fiscal debt is steadily approaching the ceiling of 65.0

Figure 3. Imports 2015, share of total—Vietnam's dependence on China



Source: General Statistics Office of Vietnam/Haver Analytics, Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.Deloitte.com

percent of GDP set by the Ministry of Finance; it is currently estimated at 62.0 percent of GDP.[14] The government's bid to maintain fiscal prudence could result in a slowdown of investment in much-needed infrastructure. Additionally, even though Vietnam continues to be a destination for the influx of export-oriented foreign direct investment (FDI), domestic support industries have not benefited from this influx. For example, only 36.0 percent of Vietnam's domestic firms are involved in export-focused industries.[15] Finally, even though Vietnam currently has a relatively young population (median age of 30.7 years), it will also be home to one of the fastest aging populations in the world. By 2040, Vietnam is projected to have three times the number of people currently aged 65 years or older.[16]

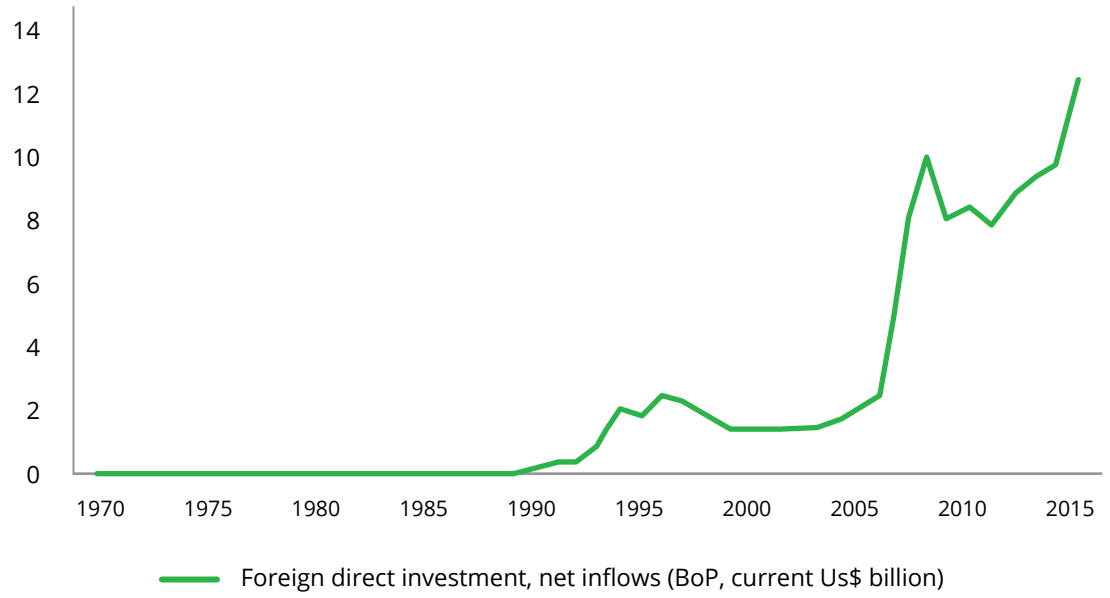
It is only right that Vietnam aims high

Despite the difficulties, there are strong reasons to remain optimistic about Vietnam. Fiscal tightening, for instance, could expedite the privatization of SOEs. An encouraging development in this direction is the lifting of restrictions on foreign investment in public SOEs (except in certain sectors). In July, it was announced that Vinamilk, one of Vietnam's best-known brands and a public SOE, will be available for 100 percent foreign ownership.[17] Vietnamese banks, in need of capital in order to meet Basel II requirements by the end of 2018, are also attracting foreign buyers. In August, Singapore's sovereign wealth fund, GIC, announced the pur-

chase of a 7.7 percent stake in one of Vietnam's largest banks.[18] Vietnam topped the *Financial Times'* emerging market index for greenfield FDI for the second consecutive year in 2015, and FDI inflow has surged 105.0 percent in the first half of 2016 relative to a year ago (figure 4).[19] Furthermore, tourist arrivals in Vietnam are up 21.0 percent in the first half of the year, following the country's visa-waiver policy.[20]

In a broader sense, Vietnam remains favorably placed, geographically (near both China and India) and diplomatically (with closer ties to the United States) to take advantage of the wind in its sails. If it steers in the right direction, it could enjoy upper-middle-class income status within the span of a generation. However, if it succumbs to the challenges that lie in its path, Vietnam could be yet another victim of the middle-income trap.

Figure 4. Foreign direct investment, net inflows (BoP, current US$ billion)



Source: The World Bank, Deloitte Services LP economic analysis.

Graphic: Deloitte University Press | DUPress.Deloitte.com

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Five decades of successful promotion of economic and intergovernmental cooperation under ASEAN resulted in member nations of the organization realizing they could achieve more if they operated as one economy. Thus was formed the ASEAN Economic Community in 2015. Its potential as a single market and production base is immense, but the community still has several challenges to overcome.

ASEAN Economic Community

Playing a key role in Asian economic integration

By Dr. Rumki Majumdar

IN response to their growing interdependence, some Asian nations formed a regional organization in 1967, called the Association of South East Asian Nations (ASEAN).[1] The primary objective was to promote intergovernmental cooperation and facilitate economic integration among its member nations, aiming to accelerate economic growth and trade. Currently, ASEAN is one of the most open economic regions in the world, whose merchandise exports account for nearly 54.0 percent of the total ASEAN GDP and 7.0 percent of global exports. Between 2007 and 2014, total trade increased by about US$ 1 trillion in the region, while the region's total foreign direct investments (FDI) inflow as a share of the total global FDI inflows increased from 5.0 percent to 11.0 percent.[2]

Over the past five decades, ASEAN as an organization has immensely helped its member nations to achieve impressive economic growth as well as regional stability by working together harmoniously. The region has grown at an annual rate of 5.2 percent between 2007 and 2015, while the poverty rate has come down from 33.0 percent to 15.3 percent since 2000. Improved trade facilitation measures have increased trade growth and interdependence within the region while reducing trading costs for all the member nations.

With time, the member nations of ASEAN realized that they could achieve more if they operated as one economy. If this 10-member organization were one economy, it would be the sixth largest in the world with a combined GDP of US$ 2.4 trillion. With over 600 million people, the potential single market is expected to be larger than that of the European Union or North America.[3] It will also be home to the third largest young labor force, next to the People's Republic of China and India (figure 1).

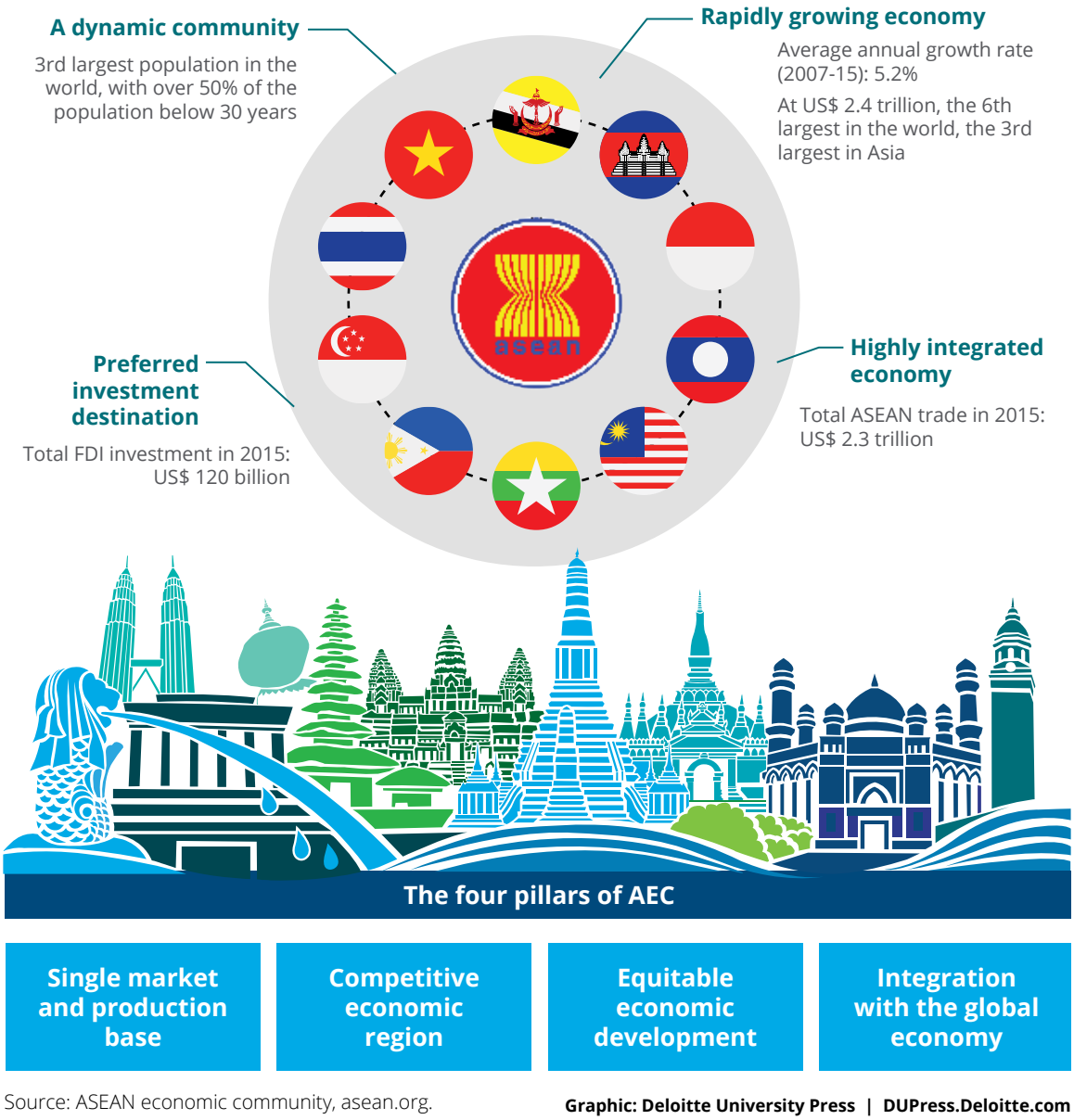
With the aim of moving closer to create a single free-trade area for the region, member nations agreed on

consolidating, integrating, and transforming ASEAN into a community called the ASEAN Economic Community (AEC) in 2007. The idea was to create an economic community, inspired by the regional integration of Europe, by bringing people closer and creating a business-friendly environment. With its focus on business and economy, AEC is expected to increase competitiveness, narrow development gaps, and improve resilience against external shocks.

The creation of AEC

AEC was formally established on December 2015, opening up opportunities for members to capitalize on their diverse resources, the comparative advantages of their geography, factors of production, and young and skilled human resources. The community is built on four interrelated and mutually reinforcing pillars (figure 1):

Figure 1. ASEAN economic community at a glance



Source: ASEAN economic community, asean.org.

Graphic: Deloitte University Press | DUPress.Deloitte.com

1. A single market and production base through free flow of goods, services, investment, skilled labor, and freer flow of capital
2. A highly competitive economic region through a business-friendly and innovation-supporting regional environment; the adoption of common frameworks and standards and mutual co-operation across economic areas; and improvement of transport and network connectivity
3. A region of equitable economic development through creative initiatives that encourage small and medium enterprises to participate in regional and global value chains
4. ASEAN's full integration into the global economy pursued through a coherent approach toward external economic relations, and with enhanced participation in global supply networks

In pursuit of the above objectives, significant progress has been made in opening up markets within the region since 2007. Measures, such as the elimination of intra-ASEAN import tariffs and restrictions in the goods and services sectors, simplification of cross-border trading processes, and harmonization of technical regulations, have created immense trading opportunities. The quality and efficiency of regulations affecting the business environment in the region have improved, particularly in terms of time and costs to trade. Cross-border movement of skilled people and professionals, along with better transportation facilities, have improved the regional competitiveness, productivity, and environment for doing business within the region. More importantly, a comprehensive economic partnership agreement and an innovation-supportive environment have been initiated to help narrow the development gap among the ASEAN member nations.

> One of the biggest challenges is the development divide—the existing gap in the degree of economic development—among the member nations.

What AEC has to offer

The formation of AEC is expected to develop cohesiveness among ASEAN members. ASEAN as a single community offers big opportunities for both investors and business corporations because of its young workforce, rising incomes, improving infrastructure, and large foreign investments. From health care to support sectors, such as airlines, telecom, and infrastructure, consumer-focused multinational corporations are eyeing the AEC's large and rising middle-income customer base to market their products, as growth opportunities in other regions seem uncertain.

At the same time, free labor mobility within the member nations offers the community a myriad opportunities to develop itself into an international business hub; Vietnam as a hub for manufacturing, Singapore for financial services, the Philippines for business process outsourcing, and Thailand for automotive. The existing free-trade agreements with some of the prominent Asian economies, such as China, Korea, India, New Zealand, and Australia (ASEAN +1) position the AEC strategically in the middle of Asia's supply chain, creating new opportunities for member nations to trade with the entire Asian region. In addition, its integration with the rest of the world has been increasing. US companies have increased the level of trade and investments in the region, as they are optimistic about the profit outlook and the region's contribution to worldwide revenues.[4]

Since 2000, FDI into the region has grown at an average rate of 14.0 percent. With rising inflow of capital into the region, stock exchanges from Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam are working together to form the ASEAN Exchange in order to promote ASEAN capital markets and offer more opportunities to investors in the region.

Challenges that lie ahead

The establishment of AEC is a major milestone in ASEAN's agenda for regional economic integration. However, the path to realizing the goal is mired with challenges. The four pillars, which are key to AEC, require specific and committed actions by ASEAN member nations, both collectively and individually. Without significant progress in each of these areas, the core objective of the AEC may not be realized.

One of the biggest challenges is the development divide—the existing gap in the degree of economic development—among the member nations. Singapore is far more advanced economically than nations such as Cambodia, Laos, and Myanmar. Consequently, the level of protectionism is not uniform between the economically more advanced and the lesser developed member nations. There are differences between member countries with respect to issues ranging from tax codes to foreign ownership restrictions and custom requirements, while progress toward smoothing out cross-border regulations governing traded services remains marginal across the region.

The other challenge is that non-tariff barriers are replacing tariffs as protective measures in order to protect local interests and economically sensitive sectors, such as agriculture and services. According to a report by the Asia Development Bank, five sectors have the lowest degree of harmonization across ASEAN's borders: media and marketing, property and construction, commodities and energy, consumer goods, and health care and pharmaceuticals.[5]

Unlike the European Union, the AEC lacks a proper framework that institutionalizes the structure of the community. The lack of a strong centralized institution and absence of an enforcement mechanism have often led to inaction by a few members, resulting in missed target deadlines. Currently, there is no appropriate mechanism to ensure compliance from member nations, which makes it difficult for private businesses to effortlessly operate across the region despite efforts by members to remove trade barriers.

The way forward

It's evident that without proper coordination of regulations and synchronization of national policies across member nations, businesses and the members themselves will not be able to realize the full benefits of the single market and production base that AEC wants to accomplish. ASEAN nations need to undergo structural reforms within and take bold measures collectively to deepen the economic integration that is key to achieving the objectives of AEC. However, this won't be an easy task, since it would require changes in domestic laws, and may even need amendments in the constitutions of the member nations, to accommodate the AEC accords.

In other words, the formal establishment of the AEC in 2015 is not the end goal, but a long-term dynamic process that will require true commitment from every member. In order to build on the achievements of the AEC, Blueprint 2025 has been adopted, which provides guidelines through strategic measures for the AEC from 2016 to 2025. That said, member nations have to be truly committed and mutually tolerant by suspending their sovereign interests and embracing the common goals laid by the AEC.

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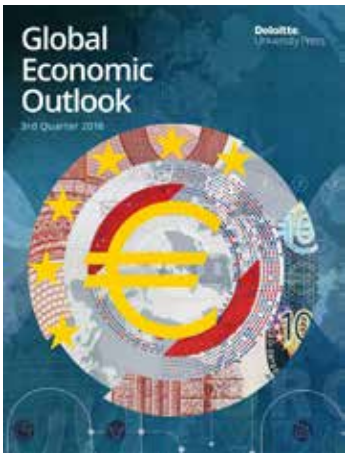

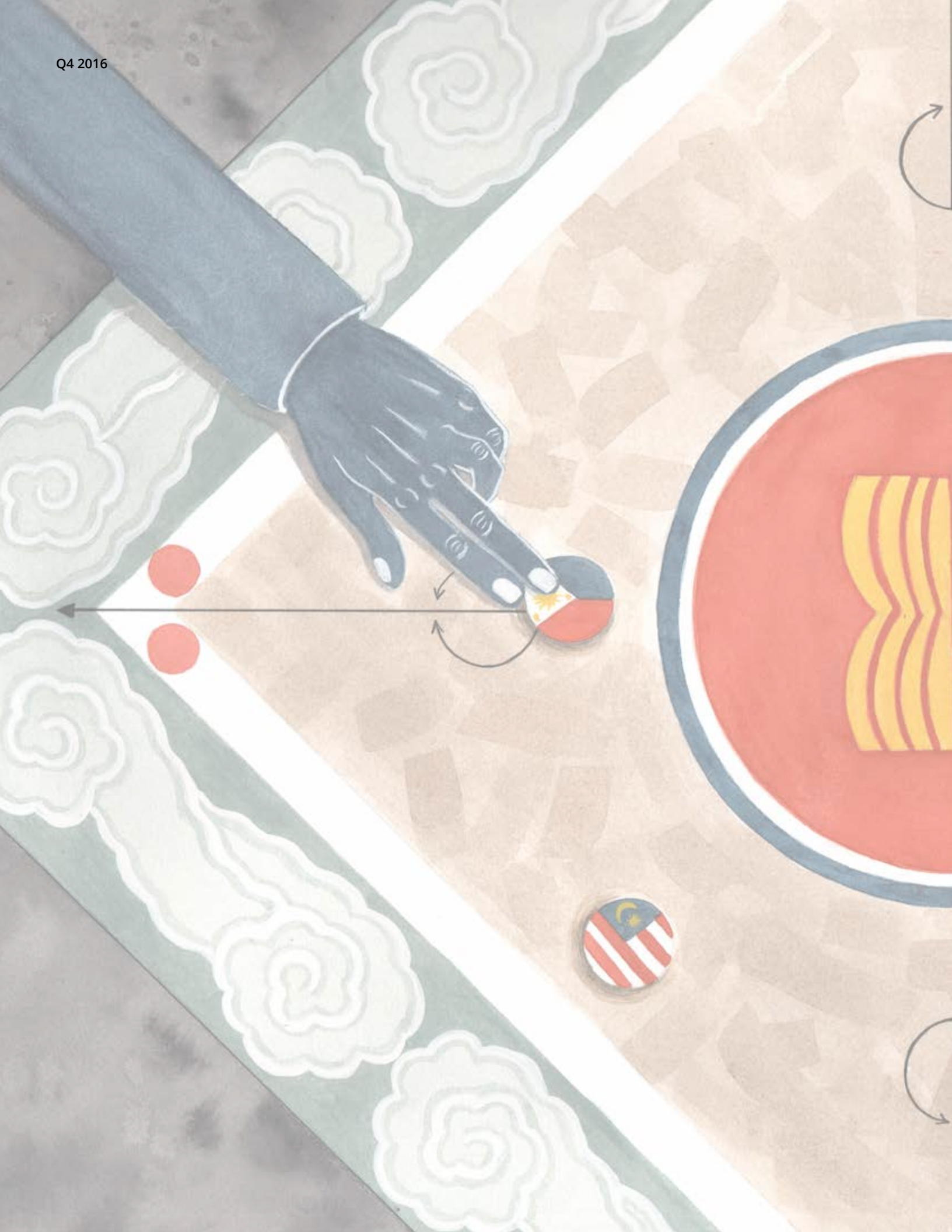

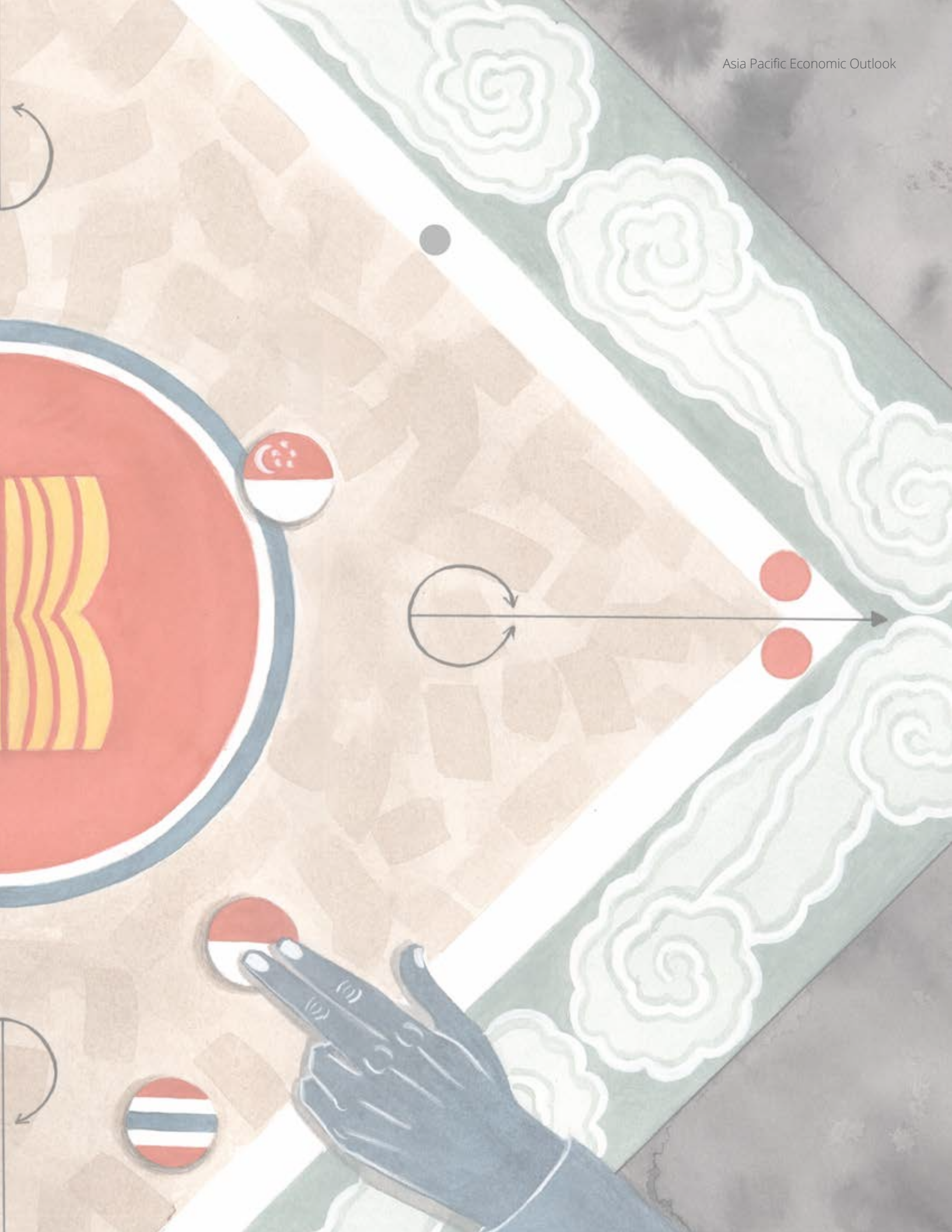

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