ARTICLE FOR THE EDGE

A GLOOMY WORLD, BUT DON'T FORGET THE SILVER LININGS FOR ASEAN

ASEAN economies certainly face growing challenges in maintaining robust economic growth in the next year. Despite signs of the US and China reaching a limited trade deal, businesses across the world remain despondent enough to cut back on their spending, thus slowing the world economy. After all, yet more downside risks are proliferating – Middle East tensions could cause oil prices to spike, the Brexit process looks ever messier, China's economy keeps slowing, and large emerging economies such as India, Argentina, South Africa and Turkey face growing difficulties.

However, even as the prospects for the next few quarters look unappealing, there is one important silver lining – the growing positive impact of production facilities being moved out of China and into Southeast Asia. Since we last discussed this 3 months ago, more evidence has emerged to suggest that its impact is becoming more powerful.

What has changed: China-based producers shifting strategy

Manufacturers in China are orchestrating an important shift in business strategy. Initially, companies in China that made goods affected by the American tariffs reacted by allocating higher production quotas to existing manufacturing facilities in jurisdictions not affected by these tariffs against China. This was why exports from developing Asian economies to the US expanded by 10% in the first half of 2019 over the same period last year while exports from China to the US fell by 12%. Vietnam (in electronics) and Bangladesh (in textiles) appear to be the main winners from such trade diversion. The Asian Development Bank believes that Malaysia, Thailand and the Philippines will also see gains.

This process of trade diversion has now given way to a more fundamental shift – the restructuring of supply chains by moving some production facilities out of China, as companies decide that the deterioration in US-China relations is here to stay.

This was brought home by the Shanghai American Chamber of Commerce's survey which showed American firms' optimism in the medium- and long-term had plunged to the lowest level in many years. The share of firms that remain optimistic about the future fell by one-fifth from the previous year to 61.4%, against normal rates of 80-90%. In addition, pessimism about the future shot up 14 percentage points. What is interesting is that it was not only the trade war that depressed business confidence. Slowing economic growth in China, rising production costs, restricted market access, poor protection of intellectual property rights and procurement practices favouring domestic suppliers were also seen as hindrances. Businesses are also complaining that local governments are not following through on the central government's edicts to improve market access to foreign firms.

In response, companies are adjusting their investment strategy. Fewer US firms are interested in expanding their footprint in China: just 47.1% of businesses surveyed planned to increase investment in China this year, compared to the 61.6% share seen in 2018. The share of firms planning to redirect investments originally planned for China to other locations in the past year reached 26.5%, up from 19.6% in 2018, mostly across the technology, hardware, software and services sectors.

It is worth digging a bit deeper into this phenomenon to understand the underlying drivers. There are two interesting aspects of this production relocation:

- **High value-added manufacturing is moving to developed economies**: There has been a significant number of instances of "re-shoring" where manufacturers look to move production facilities back to their home base even though land and labour costs can be much higher. Taiwan and Japan have seen a number of facilities being repatriated. Such re-shoring of production can make sense for higher value-added niches of manufacturing which have high profit margins and where the availability of high skills, research and development facilities and specialised suppliers of components take precedence over land and labour costs - such as in the manufacture of machinery and in electronics. Taiwan's economy has done better than expected as a result, as exports and private investment out-performed expectations.

- **Chinese firms are also moving**: Chinese manufacturers are in the same predicament as foreign ones based in China, they too have been hit by US tariffs and need to move production to countries which do not face American protectionism to the same degree. However, the Chinese relocation is more selective, involving lower-value manufactured goods. Chinese producers have complained that they cannot find the same degree of competence among component manufacturers in Southeast Asia as they can in China. There have even been a few instances of Chinese firms relocating production to a Southeast Asian country only to reverse the decision once they encountered local difficulties.

Who are the winners?

Data on investment approvals give some inkling as to which countries are benefiting. The big winners seem to be Malaysia, Vietnam and Taiwan, all of which have reported a surge in investment approvals in recent quarters, reflecting this production relocation. Interestingly, India which has not done well in attracting manufacturing investments, is seeing some incipient signs of a pick-up - it could be benefiting in a few narrow niches. Another laggard in attracting export-oriented manufacturing foreign investment, the Philippines, has also seen an uptick, albeit from low levels.

Indonesia, however, remains a disappointment, with the data suggesting that the production relocation that is boosting the fortunes of the above countries is bypassing Indonesia. As for Thailand, the investment approvals data have, so far, not shown as strong a pick up as in the rest of the region. However, our recent discussions with industrial estate and logistics firms there suggests that Thailand, too, will be a winner from production relocation. The political uncertainty in the run-up to the elections and the delayed formation of a coalition government may have resulted in firms delaying investment decisions for Thailand until recently.

But the region needs to address internal weaknesses

The mixed experience of Chinese firms relocating to Southeast Asia serves as a reminder that the region still has some way to go before it can reap the full benefits of the restructuring of supply chains. Much needs to be done:

- First, there is a real need to address shortfalls in skills development. The region still struggles to produce the technical supervisors and production foremen needed in modern manufacturing plants.

- Second, despite progress in countries such as Indonesia, businesses still find the business environment in many parts of Southeast Asia challenging. Under President Jokowi's vigorous reform programme, Indonesia has leapt ahead in the World Bank's Ease of Doing Business rankings, but this has not been enough to persuade foreign investors to change their minds on Indonesia as a base for export-oriented manufacturing.

- Third, infrastructure remains a constraint in many parts of the region. Even in Vietnam, where infrastructure has been relatively good, the rapid expansion of manufacturing plants is beginning to place a strain on power and transportation capacity. Just this week, Vietnam's Prime Minister Nguyen Xuan Phuc expressed his concern that power shortages could emerge by 2021 and called on state planners to step up the pace of construction of power generation plants.

- Fourth, component suppliers in the region need help in moving up the value chain so that they can match their counterparts in China.

- Fifth, economies of scale are increasingly important in determining competitiveness in the 21^{st} century economy. China with its vast and unified market retains formidable advantages over ASEAN's smaller and much more fragmented market. ASEAN needs to work harder at creating these scale economies for its companies. The ASEAN Economic Community, for instance, is a move in the right direction but its implementation lags behind the rhetoric, which means that ASEAN-based businesses struggle to gain from the scale advantages that Chinese firms enjoy.

The good news is that policy makers in the region have got the message and are moving in the right direction.

In Indonesia, President Joko Widodo is showing that he is deadly serious about getting Indonesia into the race for foreign investment in export-oriented manufacturing. He has shown his intention to compete for investment dollars by proposing institutional reforms to improve trade and investment promotion activities. The most encouraging development has been the clear signals he has been sending that he is prepared to use up his political goodwill to push through reforms to Indonesia's labour laws which have deterred foreign investors. We believe that a big push for labour law reforms will be initiated once he is sworn in for his second term and once his new cabinet is in place. If President Joko can pull this reform off, it will be a game-changer in enhancing Indonesia's attractiveness to foreign investors.

Thailand is also in the game. Its investment promotion board announced a package of incentives aimed at stealing a march on its regional peers in wooing relocating companies to choose it as a production base. The cornerstone of the package was a 50% tax cut for five years on investment commitments worth at least THB1bn or USD32.7mn by 2021.

Malaysia is not far behind. It is also putting up a fight by forming a new panel to expedite investment approvals. At its first meeting, the new National Committee on Investment I (NCII) passed investments worth MYR2.2bn or USD526mn. Approval times have also been slashed from three months to just one.

Conclusion: in a more competitive world, ASEAN governments need to be ahead of the curve

The stakes are high in the production relocation game. With the right policies in place, the region could leverage off this once-in-a-generation opportunity to emerge, once again, as one of the world's premier destinations for foreign investment – as it was in the 1990s before the 1997 financial crisis and China's surge took the lustre off ASEAN. If they get it right, economic growth rates of 7% and above could be achievable. So far, the region's leaders have shown that they see the opportunity and are putting in place the reform needed. If this pace of reforms can be maintained, Southeast Asia could be on the verge of a major surge.

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