

## ARTICLE FOR THE EDGE

### CAN SOUTHEAST ASIA REGAIN ITS MOJO?

The Association of Southeast Asian Nations (ASEAN) has just celebrated its 54<sup>th</sup> birthday but it was not entirely a happy occasion. The past few months have brought an unrelenting flow of bad news for the region. After initially managing the COVID-19 pandemic relatively well last year, the region has suffered a troubling surge in infections and deaths this year. Gloomy reports abound in the international media, of the region as the epicentre of the pandemic, of cemeteries and crematoria filling up and patients struggling to secure medical care. Adding to the gloom has been the undeniable deterioration in political risks, particularly in Myanmar but also in other parts of the region.

So, is this region going to perennially be the place where hope rises every now and then, only to be dashed? Our view is the region's weaknesses cannot be simply wished away, they are real. However, we also assess that the main downside risks can be mitigated. Moreover, there are also some strong positive trends favouring the region. So, taken as a whole, we believe that the pessimism over the region in the international media is somewhat overdone.

#### **The region must find a way to mitigate its very real weaknesses**

Southeast Asia with its 660 million people and USD3 trillion of GDP carries weight in the world economy. It has an array of dynamic companies in diverse sectors and some of its start-ups have grown into unicorns, making the region of growing interest to venture capitalists. With its strategic location between China and India and straddling some of the most important sea lanes of communications in the world while also possessing rich resources, it is also of geo-political importance. Yet it is fair to say that it will keep disappointing hopes of fulfilling its potential unless it finds a way around some major deficiencies.

The first of these deficiencies is the region's political challenges. These political problems are unlikely to be eliminated but we believe they can be sufficiently contained to prevent the region as a whole from suffering. Currently, the major blemish on the region's political outlook is the crisis in Myanmar. The coup in February has shattered the country – there has been strong resistance to the military takeover, with even the majority Bamar community pushing back, sometimes even employing violence. Ethnic insurgencies have also been re-ignited. Some learned commentators have warned that Myanmar could turn into a failed state, in which the central government might lose control over much of its territory, allowing drug traffickers, terrorists and other nefarious elements to use it as a base to threaten its neighbours.

While ASEAN's response has been criticised in some quarters as weak and ineffectual, it is the only game in town. No other country or international organisation is willing or able to resolve the crisis. What ASEAN can do is to help coordinate the regional response so that the crisis is contained within the country, not spill over into the rest of the region. And it is probably the

one honest broker who can offer its mediation service when the government in power in Yangon is ready to work out a political accommodation with its rivals.

Beyond Myanmar, there are other domestic political crises that need to be mitigated. In Malaysia, a resolution to the grim uncertainty of recent months appears close, with a new prime minister in place and a general election not far off. The renewed protests in Thailand are, however, more threatening and there does not appear to be an early end in sight. The good news is that Indonesia has effected a successful transformation from an authoritarian regime to a fairly democratic one. If the region's giant can be stable and continues to demonstrate an ability to overcome challenges, as it has, then things cannot be so bad for the region.

Finally, there are concerns that Southeast Asia will be one of the main arenas for US-China contestation. The US opposes China's seizure of territories in the South China Sea and their conversion into military bases. Consequently, the US and its allies have deployed more naval assets into these waters to challenge China's occupation. But what does that mean in concrete terms? There is little likelihood of a hot war in the region – neither the US nor China want to risk an outright military clash. Even if there is an accidental clash of some kinds, it is almost certain that the two sides would work feverishly to prevent an escalation into something more dangerous. Certainly, the countries bordering the South China Sea will have to spend more on defence as a result. For instance, they will need to expand their navies and air forces, so there will be a diversion of resources to unproductive military areas instead of to building infrastructure and schools. But, we do not see greater dangers than that.

In short, an overhang of political unpredictability will remain as a cloud over some countries' prospects but the most dangerous political risks such as Myanmar or a US-China clash can be kept in check. For most of the region, there might be political uncertainty in terms of which leader or party is in power – but it is unlikely that there will be severe political dislocations that mar economic activity for prolonged periods.

Second, the pandemic has to be brought under control. The only way is to ramp up the vaccination programme and the good news is that this is happening. Note how Malaysia's vaccine roll-out was initially slow but today more than half the population has had one dose and there is a good chance that most of the population will be fully inoculated by October. Indonesia is also accelerating its vaccination programme. We believe that most of the region would have vaccinated a critical mass of its population by the middle of next year. This is not ideal but it is a decent outcome and it is better than many other emerging economies.

Third, the region also needs to do something about its incomplete economic integration so as to realise the synergies that can be gained from a more unified market. The ASEAN Economic Community came into being in early 2016 – its progress is slow but over time it holds promise. In the meantime, as the Regional Comprehensive Economic Partnership agreement is implemented, the region will gain as more trade opportunities emerge with China, Japan, South Korea, Australia and New Zealand. In other words, the progress is too slow but there will still be some progress in integration.

## **The good news is that there is still a powerful growth story in ASEAN**

A more balanced picture of the region should recognise that there are several upbeat factors helping the region.

First, the region has gradually been getting its act together on infrastructure. In the years leading up to the pandemic, for instance, Indonesia and the Philippines had increased infrastructure spending as a share of GDP by about 2–3 percentage points. That was encouraging because these two countries had been laggards in building infrastructure. The pandemic has slowed things down but from next year, we are likely to see a revived push to build roads, railways, power plants, ports, airports and mass transit systems – not just in Indonesia and the Philippines but also in Thailand and Malaysia. We have noticed that even small improvements in road networks can spur increased investment: For example, we have seen investment rates improve in central and east Java with better roads. As the transport network grows in Indonesia, one of its major drawbacks, its high logistical costs, will be eased and competitiveness will improve. Better infrastructure will also attract more foreign investment.

Second, the past ten years have seen the region make strides in reforms that improve economic efficiency. Indonesia, Malaysia and the Philippines have enjoyed large gains in the World Bank's ease of doing business rankings. This push for deregulation has continued even during the pandemic. For example, Indonesia has passed an omnibus reform bill which makes its labour market more flexible – redundancy costs have been cut and hiring and firing workers made more flexible. Minimum wages will also be formulated in a more rational manner from now on. Indonesia has also launched a one-stop "Online Single Submission" system to speed up approvals of new investments. It has also revamped its negative list of sectors where foreign investors are barred, making it much easier to attract the foreign investment so critical to raising Indonesia's growth prospects.

Third, the region will also gain from changes in the structure of competitiveness. China suffers from two challenges to its competitiveness: Its population growth is slowing and labour – whether low-cost or not – will become harder to find. Moreover, US-China frictions will also cast a pall over locating export-oriented production in China. All this will encourage companies to pursue a China Plus One strategy, where production is diversified beyond just China in order to overcome protectionist or other measures that the US and its allies might impose on Chinese-made goods. China will also have to move up the value chain, and in the process many labour-intensive activities will be relocating elsewhere. In all these moves, Southeast Asian locations such as Vietnam and Cambodia will be the main beneficiaries. Over time, Indonesia, too, can gain if it keeps up the pace of its reforms.

Fourth, the region has also improved its resilience – its ability to bounce back from shocks. Note how much more sturdy the region's currencies have been during recent crises such as the sharp financial market corrections last year. This year, even as financial markets began to

fear a tightening of monetary policy by the US central bank, the region's currencies and equity and bond markets have held up reasonably well.

**The net effect: higher investment rates and higher growth**

Pulling all this together, we would say that there is enough progress in the region to allow the investment share of GDP to rise. Gains from better infrastructure, higher economic efficiency and stepped-up production relocation should spur more foreign and domestic investment. Moreover, there will be higher productivity as a result of the deregulation and better functioning labour markets. The combination of raised investment and enhanced productivity will translate into higher rates of growth.

To conclude, we would say that, without a doubt, Southeast Asia has its share of challenges. But, over the years, it has demonstrated an ability to learn from its setbacks and overcome the root causes of those setbacks. The best example of this ability was in how the region bounced back from the searing effects of the Asian financial crisis of 1997–98. We are confident that Southeast Asia can repeat this performance and deliver good performance in the post-pandemic period.

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