

POLICY NOTE ON ASIA

EXPANDING BUSINESS
THROUGH REGIONAL
INTEGRATION



INVESTMENT
ENERGY RISK MANAGEMENT
INFRASTRUCTURE INNOVATION
POPULATION GROWTH MIDDLE CLASS
GREEN GROWTH COMMODITIES
SKILLS REGULATIONS TRADE
PRODUCTIVITY
INDUSTRIALISATION
CREDIT

Expanding business through regional integration

Regional economic integration progressed rapidly in 2015 and 2016 in Asia, with important consequences for future trade and development. This note provides insights and suggested policy recommendations from the business sector on the trade and investment implications of enhanced economic integration in Asia. The analysis builds on discussions at the OECD Emerging Markets Network (EMnet) meeting on doing business in Asia, “Expanding Business through Regional Integration”, held on 8 March 2016 at the OECD headquarters in Paris as well as on the analysis of the *Economic Outlook for Southeast Asia, China and India*, in addition to desk research and bilateral discussions with EMnet members.

Key messages include:

- Strengthening regional ties can play a key role in sustaining growth and build new opportunities for trade, investment and development, provided that adequate reforms are implemented to enhance the investment climate, improve the quality of infrastructure, increase talent retention and foster more linkages with small- and medium-sized enterprises (SMEs).
- The “interim period” in which regional trade agreements are still being negotiated or have yet to be ratified produces some uncertainty for businesses. In the meantime, bilateral agreements are instrumental to promote regional trade.
- Firms see wide development gaps amongst countries, persistent non-tariff barriers and restrictive policies in the services sector as key challenges to further integration and development.
- Despite some progress, local companies should be doing more to capture higher parts of global value chains (GVCs), by producing more value-added products and using acquisitions to upgrade brand names and technology.
- Financially viable projects are crucial to channelling capital into infrastructure investments, while financial markets need to be further developed to support this aim.
- On the energy front, the region is expected to shift further to renewables, as their competitiveness improves and favourable government policies are implemented.
- The Chinese slowdown provides both opportunities and challenges for the region, and companies can take advantage of this. In particular, China’s transition is an opportunity to procure low-cost commodities and further support domestic-led growth.

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EMnet gathers top executives (chief executive officers, vice presidents, managing directors, chief financial officers, heads of strategy, chief economists) of multinational companies from diverse sectors, willing to engage in debates with high-level policy makers, including heads of state and ministers, and OECD experts.

EMnet events are closed to the public and media and operate under Chatham House rule to encourage open and dynamic discussions on doing business in Africa, Asia and Latin America.

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ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AEC	ASEAN Economic Community
AIIB	Asian Infrastructure Investment Bank
APEC	Asia-Pacific Economic Cooperation
ASEAN	Association of Southeast Asian Nations
BCIM	Bangladesh-China-India-Myanmar Economic Corridor
CLM	Cambodia, Lao PDR and Myanmar
CLMV	Cambodia, Lao PDR, Myanmar and Viet Nam
CPEC	China-Pakistan Economic Corridor
COP21	21st Session of the Conference of the Parties to the United Nations Framework Convention on Climate Change
ERIA	The Economic Research Institute for ASEAN and East Asia
FDI	Foreign Direct Investment
GVCs	Global value chains
GW	Gigawatt
IEA	International Energy Agency
KwH	Kilowatt-hour
MW	Megawatt
M&As	Mergers and Acquisitions
OBOR	One Belt, One Road Initiative
OECD	Organisation for Economic Co-operation and Development
PPP	Private-public partnerships
PV	Photovoltaic
RCEP	Regional Comprehensive Economic Partnership
SMEs	Small and medium-sized enterprises
TPP	Trans-Pacific Partnership
UNFCCC	United Nations Framework Convention on Climate Change

ASIA'S ECONOMIC AND BUSINESS OVERVIEW

Economic trends in Emerging Asia

Emerging Asia (Southeast Asia, China and India) is the most dynamic region in the world. Economic growth is expected to remain robust over the medium term, backed by solid macroeconomic fundamentals and domestic demand. Future prospects may, however, be affected by China's slowdown as export demand drops and investment flows decline. US monetary tightening also is likely to depress regional capital inflows.

Asia will account for 34% of the world's gross domestic product (GDP) by 2019 (OECD, 2015a). GDP growth in the 12 Emerging Asia countries (ASEAN-10,¹ People's Republic of China [hereafter "China"] and India) will be robust with a projected annual average growth rate of 6.5% for 2016 and 6.4% for 2017.²

Table 1.1. Real GDP growth of Emerging Asia
Annual percentage change

Country	2015	2016	2017	2017-21 average	2011-13 average
ASEAN-5 countries					
Indonesia	4.8	5.0	5.1	5.4	6.2
Malaysia	5.0	4.2	4.5	4.7	5.2
Philippines	5.9	6.8	6.2	6.1	5.9
Thailand	2.8	3.2	3.3	3.6	3.2
Viet Nam	6.7	6.0	6.2	6.2	5.6
Brunei Darussalam and Singapore					
Brunei Darussalam	-0.6	0.7	2.0	1.8	0.9
Singapore	2.0	1.8	2.0	1.8	4.1
CLM					
Cambodia	7.0	7.1	7.1	7.3	7.3
Lao PDR	7.4	7.1	7.3	7.5	8.1
Myanmar	8.7	8.3	8.4	8.5	6.9
China and India					
China	6.9	6.7	6.4	6.0	8.2
India	7.6	7.4	7.6	7.3	5.5
Average of ASEAN-10 countries	4.7	4.8	4.9	5.1	5.4
Average of Emerging Asia	6.6	6.5	6.4	6.2	7.0

Note: The cut-off date of data is 28 November 2016. Weighted averages are used for ASEAN and Emerging Asia. The figures for China, India and Indonesia (2016 and 2017 projections) are based on the OECD Economic Outlook No. 100, November 2016. India data refer to fiscal years starting in April.

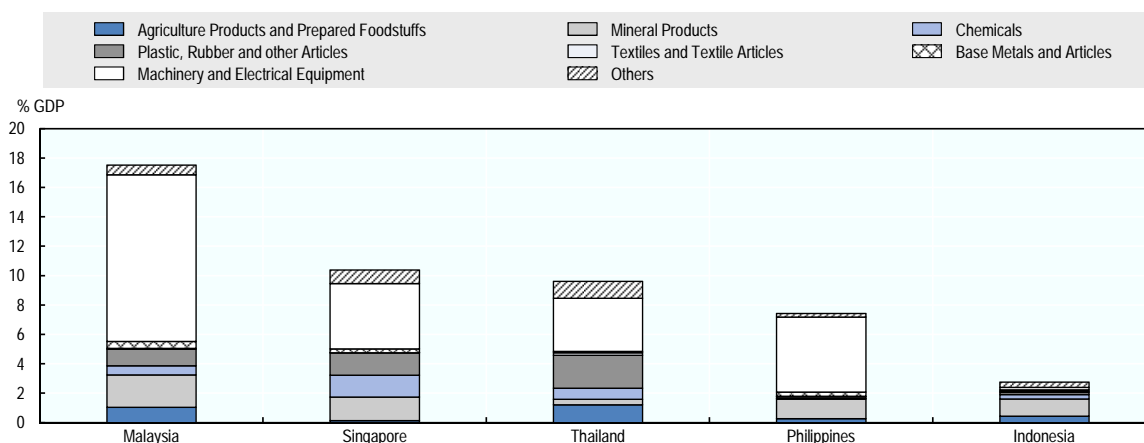
Source: OECD Development Centre, MPF-2017 (Medium-Term Projection Framework), cited in OECD (2017), *Economic Outlook for Southeast Asia, China and India 2017*, <http://dx.doi.org/10.1787/saao-2017-en>. For more information on the MPF, please see www.oecd.org/dev/asia-pacific/mpf.htm.

Growth paths differ substantially. The Philippines and Viet Nam are likely to lead ASEAN-5 growth with an expected growth of 6.8% and 6.0%, respectively, in 2016, and 6.2% for both in 2017. The low-income countries of Cambodia, Lao People's Democratic Republic (hereafter "Lao PDR") and Myanmar also are expected to sustain their high levels of growth. Cambodia and Lao PDR should maintain growth at 7.1% for 2016, and a projected 7.1% for Cambodia and 7.3% for Lao PDR in 2017. Myanmar's predicted growth is 8.3% for 2016 and 8.4% for 2017. The economies of Southeast Asia's major oil- and gas-exporting countries – Malaysia and Brunei Darussalam – were impacted by the decline in global energy prices; despite low oil prices, Brunei Darussalam was able to limit economic recession from -2.3% in 2014 to -0.6% in 2015, with further recovery expected in both 2016 and 2017 as oil prices are anticipated to rise. Malaysia's slowdown is expected to improve slightly with its 4.2% growth rate in 2016 projected to rise to 4.5% in 2017.

The outlook for China and India is expected to differ, with China continuing to slow to 6.4% in 2017 while India will sustain growth (7.6%). In China, growth prospects are slowing as the manufacturing sector undergoes adjustment to manage excess capacity. In contrast, India's development is supported by robust growth in manufacturing, improvement in foreign-investment regulations and the benefits of low oil and gas prices. Nonetheless, India faces critical challenges, such as structural reform implementation and the need to achieve inclusive development (OECD, 2016b).

China's slowing growth will affect the region through declining export demand, reduced foreign direct investment (FDI) and greater financial market volatility. Countries with extensive merchandise exports to China, such as Malaysia (12% of GDP), Singapore and Thailand (6-8% of GDP), already are feeling the impacts of reduced demand (see Figure 1.1). Malaysia and Thailand in particular rely on FDI inflows from China as an important source of investment. Increasing financial links in the region also heighten the spillover effects of financial market fluctuations. In the short term, China's slowdown will be a demand shock to neighbouring countries, which can be partially mitigated by domestic macroeconomic policies. In the longer term, China's slowdown is likely to bring about structural changes in industry and trade in many Asian countries (OECD, 2016b).

Figure 1.1. Exports to China by major product items in selected countries, 2014



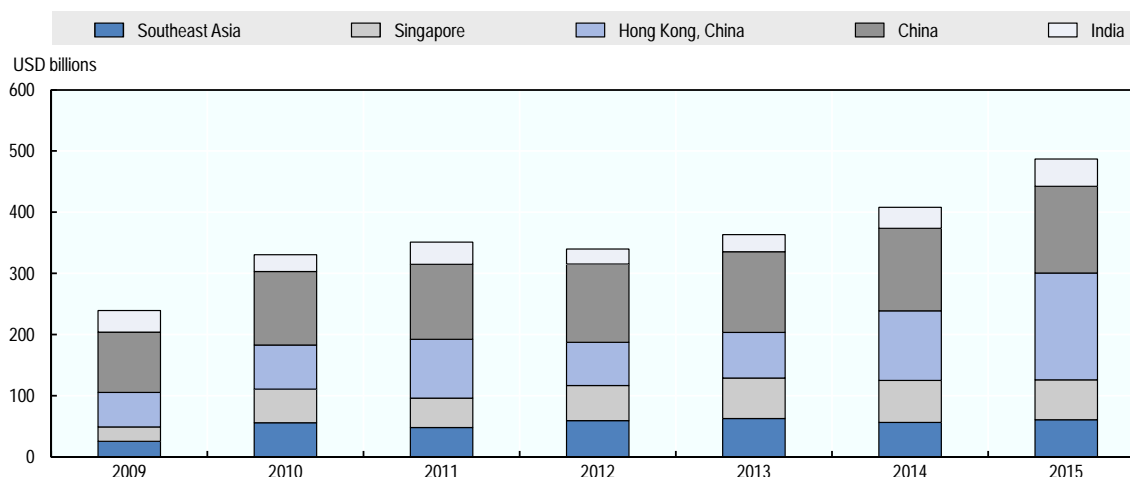
Source: CEIC, cited in OECD (2016b), *Economic Outlook for Southeast Asia, China and India 2016*, <http://dx.doi.org/10.1787/saeo-2016-en>.

Rising FDI inflows

According to data from UNCTADstat (UNCTAD, 2015), Emerging Asia accounted for 17% of global FDI inflows in 2015 with USD 305.5 billion in investment, a 6.1% increase from the previous year of FDI into the region.³ China, India and Singapore dominate FDI in Emerging Asia. East Asia received the bulk of the FDI boost due to equity investment in Hong Kong (China), making Hong Kong the largest host economy of FDI inflows to East Asia and the second-largest in the world.

FDI into Southeast Asia⁴ grew slightly in 2015 to USD 126 billion, up from USD 125 billion in 2014. Southeast Asian FDI growth was impacted by decreased inflows to Singapore and Indonesia, due mainly to declines in greenfield investments by multinational enterprises and to short-term economic uncertainty. Singapore's FDI inflows decreased by 5% to USD 65 billion, while Indonesia's FDI inflows fell by 29% to USD 16 billion. The smaller ASEAN economies fared better. FDI to Myanmar increased by 200%, bringing FDI inflows to USD 3 billion, while inflows to Thailand tripled, reaching USD 11 billion (UNCTAD, 2016).

Figure 1.2. FDI inflows into Emerging Asia and Hong Kong (China), 2009-15



Note: Southeast Asia includes: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Thailand, Timor-Leste and Viet Nam.

Source: UNCTADstat database, <http://unctadstat.unctad.org> (accessed 20 December 2016).

Emerging trends in ASEAN multinational corporations and M&As

Multinational corporations from emerging markets are now an important force in international business. These companies have specific characteristics, differentiating them from their counterparts from developed markets (e.g. family or state ownership) (Casanova and Miroux, 2016). They also have the ability to survive challenging investment climates in emerging markets such as inadequate infrastructure, poor governance, regulatory uncertainties and weak educational institutions (Casanova and Miroux, 2016).

Firms in Emerging Asia are becoming increasingly active in the region as well as globally. Exports are rebounding and flows of outward FDI are growing. Large firms, particularly from China, India, Malaysia, Singapore and Thailand, are expanding their trade and investment relationships within the region and beyond. Intra-ASEAN trade has surged more than sevenfold in the past 20 years, from USD 82 billion in 1993 to approximately USD 600 billion in 2014, 24% of which was intra-ASEAN total trade (ASEAN, 2015).

Mergers and acquisitions (M&As) are a means by which multinational corporations can enter new markets. Firms from larger ASEAN countries tend to conduct M&As in other ASEAN countries. For example, Singapore and Malaysia – ASEAN’s two largest economies – conduct most of their M&As in ASEAN countries. From 2003 to 2014, 664 M&A deals from Singapore went to the ASEAN region, compared to 595 deals in OECD countries. Similarly, in Malaysia 496 deals went to ASEAN countries as opposed to 256 in OECD countries. Globally, ASEAN M&A deals are concentrated in the manufacturing and service sectors, such as food and beverages as well as automotive and consumer products.

In a period of global economic uncertainty, strengthening regional ties and boosting regional trade can be tools to promote economic growth and private investment. The following section will discuss recent ASEAN Economic Community (AEC) developments as well as new trade agreements under discussion.

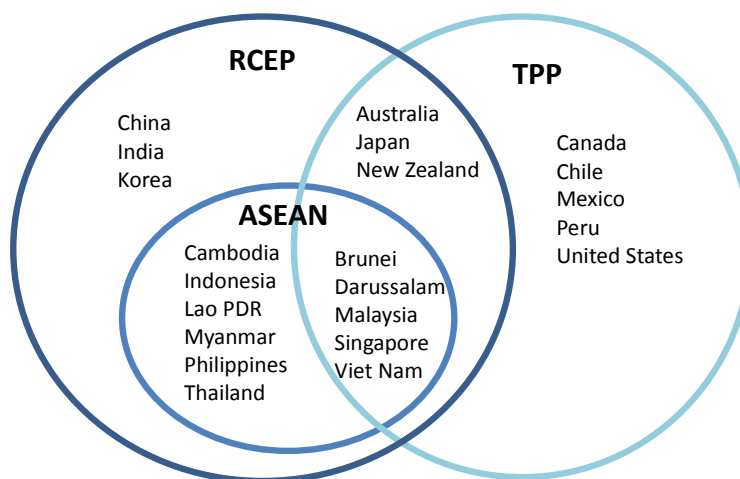
REGIONAL INTEGRATION INITIATIVES IN ASIA

Given the size of the market, strengthening regional ties can further promote growth, generate new business opportunities and bolster investor confidence. In 2013, Emerging Asia accounted for 70% of the world's population and 26% of global GDP (ASEAN, 2014). The ASEAN region alone accounted for 11% of total global FDI inflows in 2014, compared with only 5% in 2007 (ASEAN, 2015). Furthermore, the ASEAN region is projected to average a 4.9% growth rate in 2017 (OECD, 2017). According to the Asian Development Bank (ADB), this growth rate may increase to 7% by 2025 and create 14 million additional jobs, driven by trade and investment facilitated by a single economic community (Groff, 2016).

Various initiatives to strengthen regional integration are in progress, such as the ASEAN Economic Community (AEC), the Trans-Pacific Partnership (TPP), the Regional Comprehensive Economic Partnership (RCEP), Asia-Pacific Economic Cooperation (APEC) and Chinese-led initiatives, such as the Asian Infrastructure Investment Bank (AIIB) and the One Belt, One Road (OBOR) Initiative. These initiatives can generate new trade and investment opportunities by forming common markets, reducing tariff and non-tariff barriers and improving regional infrastructure.

Regional trade agreements are, however, still evolving; negotiations for the RCEP are ongoing and the TPP is awaiting signatory ratification. It is therefore unclear how the agreements ultimately will affect regional trade and investment dynamics. Regardless of outcome, it is evident that the increasing network of regional trade agreements, often referred to as the “spaghetti bowl” – or the “noodle bowl” when referring to Asian trade agreements (Figure 1.3) – can bring about complexities for consolidation.

Figure 1.3. ASEAN, TPP and RCEP member states



Note: The relative size of the circles does not reflect the levels of importance. The figure is based on information up to date in December 2016.

Source: Authors' design

This section highlights a few major initiatives that have the potential to play a key role in furthering regional integration, sustaining growth and generating new trade and investment opportunities.

ASEAN Economic Community (AEC)

ASEAN was established in 1967 to accelerate economic and social development in the region and promote increased peace and stability. Regional integration in ASEAN has expanded through various frameworks and agreements since the 1980s, increasing its geographic coverage and the issues addressed. Since the 1990s, ASEAN has deepened its focus on integration through trade and investment. The establishment in 2015 of the AEC – a process for economic integration amongst the ten ASEAN members – is a milestone and has significant implications for the private sector.

The AEC aims to be a single market and production base allowing the free flow of goods, services, investments and skilled labour, and the freer movement of capital across the region. It is expected to accelerate growth in the ASEAN region, where GDP nearly doubled between 2007 and 2014 to reach USD 2.6 trillion (ASEAN, 2015).

Table 1.2. Key features of the AEC

Type	Economic community
Current status	Established 31 December 2015
Members	Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam
Scope	Trade in goods and services, investment and capital market liberalisation, competition and consumer protection, intellectual property (IP), infrastructure and connectivity, small- and medium-sized enterprises (SMEs), food, agriculture and forestry, tourism, and human and social development
Size	622 million people, combined GDP of USD 2.6 trillion (in 2014)
Vision	The AEC Blueprint is built on four interrelated and mutually reinforcing pillars: i) a single market and production base; ii) a highly competitive economic region; iii) a region of equitable economic development; and iv) a region fully integrated into the global economy.

Source: ASEAN (2014), *ASEAN Economic Community Chartbook 2014*, www.asean.org/storage/images/2015/february/asean_publications_2014/12.%20December%202014%20-%20AEC%20Chartbook%202014.pdf.

Trans-Pacific Partnership (TPP)

The TPP is a mega-regional trade agreement concluded in 2015 amongst twelve Pacific Rim countries. In addition to eliminating tariffs, the distinctive feature of the TPP agreement is that it covers nonconventional areas, such as government procurement rules and competition policy. It has an investor-state dispute settlement mechanism. Signed in February 2016, the TPP has yet to be ratified. The future of the agreement, and the participating countries, remains highly uncertain given recent political developments. Notably, in January 2017 the United States withdrew as a signatory of the TPP and from TPP negotiations via presidential memorandum (White House, 2017).

Table 1.3. Key features of the TPP

Type	Trade agreement
Current status	Signed 4 February 2016, to be ratified
Signatories	Australia, Brunei Darussalam, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, United States*, Viet Nam
Scope	The TPP agreement consists of 30 chapters including trade in goods, textiles and apparel, rules of origin, state-owned enterprises and designated monopolies, intellectual property, SMEs, dispute settlement, etc.
Size	800 million people, 40% of global trade
Vision	Promote economic growth, support the creation and retention of jobs, enhance innovation, productivity and competitiveness, raise living standards, reduce poverty, and promote transparency, good governance, and enhanced labour and environmental protections

Note: *The United States announced on 23 January 2017 via presidential memorandum its intention to withdraw its signature from the TPP (White House, 2017).

Source: Australian Government (n.d.), *Trans-Pacific Partnership Agreement*, <https://dfat.gov.au/trade/agreements/tpp/Documents/tpp-overview.pdf> (accessed 30 December 2016); BBC News (2015), "Trans-Pacific free trade deal agreed creating vast partnership", www.bbc.com/news/business-34444799; USTR (n.d.), The Trans-Pacific Partnership, <https://ustr.gov/tpp/> (accessed 19 April, 2016).

Regional Comprehensive Economic Partnership (RCEP)

The RCEP is a free trade agreement under negotiation between the ten ASEAN member states and six of ASEAN's free trade partners. The RCEP initiative is an ASEAN-led process with the vision to be a "modern, comprehensive, high-quality and mutually beneficial economic partnership agreement" (ASEAN, 2013).

Table 1.4. Key features of the RCEP

Type	Trade agreement
Current status	Under negotiation, with little progress made since the last round, held in New Zealand on 12 August 2016
Countries involved	ASEAN (Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Viet Nam), ASEAN free trade partners (Australia, China, India, Japan, Korea, New Zealand)
Scope	Trade in goods and services, investment, economic and technical co-operation, intellectual property, competition, legal and institutional matters
Size	3 billion people, combined GDP of USD 22.7 trillion and 30% of global trade (in 2014)
Vision	The RCEP aims to broaden and deepen economic engagements between ASEAN and its free trade partners; the RCEP would promote greater economic integration, support equitable economic development and strengthen economic co-operation amongst the countries involved.

Source: ASEAN (n.d.), *Building the ASEAN Community*, www.asean.org/storage/images/2015/October/outreach-document/Edited%20RCEP.pdf; MTI (2014), Factsheet: What You Need to Know About Regional Comprehensive Economic Partnership (RCEP), [www.mti.gov.sg/MTIInsights/SiteAssets/Pages/FACTSHEET-WHAT-YOU-NEED-TO-KNOW-ABOUT/Factsheet%20on%20RCEP%20\(June%202014\).pdf](http://www.mti.gov.sg/MTIInsights/SiteAssets/Pages/FACTSHEET-WHAT-YOU-NEED-TO-KNOW-ABOUT/Factsheet%20on%20RCEP%20(June%202014).pdf)

Asia-Pacific Economic Cooperation (APEC)

The APEC, established in 1989, is an economic forum comprising 21 member economies. Members seek to achieve free trade and investment in the region by 2020 and encourage greater regional co-operation to address economic and social dimensions of development. The 24th APEC Economic Leaders Meeting and the 28th Annual Meeting were held in Peru in November 2016.

Table 1.5. Key features of the APEC

Type	Economic forum
Current status	Established in 1989; the 24 th APEC Economic Leaders Meeting and the 28 th Annual Meeting were held in Peru in November 2016.
Member economies	Australia, Brunei Darussalam, Canada, Chile, China, Hong Kong (China), Indonesia, Japan, Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, Philippines, Russia, Singapore, Chinese Taipei, Thailand, United States, Viet Nam
Scope	Trade and investment liberalisation, business facilitation, economic and technical co-operation on a wide range of issues
Size	2.8 billion people, 57% of global GDP and 49% of global trade (in 2014)
Vision	Support sustainable economic growth and prosperity in the Asia-Pacific region

Source: APEC (n.d.), *Achievements and Benefits*, www.apec.org/About-Us/About-APEC/Achievements%20and%20Benefits.aspx.

Chinese-led regional integration initiatives

In recent years China has played a strong role in promoting regional integration in Emerging Asia. Two of the most prominent Chinese-led efforts include the Asian Infrastructure Investment Bank (AIIB) and the One Belt, One Road (OBOR) Initiative, both focusing on the importance of infrastructure as a facilitator of regional integration.

The Asian Infrastructure Investment Bank (AIIB)

The AIIB is a China-led multilateral development institution that opened for business in January 2016 with USD 100 billion in capital (AIIB, 2015). In co-operation with existing multilateral development banks and 57 member countries, the AIIB seeks to contribute to Asian infrastructure development and regional connectivity (AIIB, 2016a). The bank already is financing infrastructure projects in Indonesia, Tajikistan, Bangladesh and Pakistan (AIIB, 2016b).

The One Belt, One Road (OBOR) Initiative

China also has led other infrastructure development initiatives in the region, including OBOR, an economic development initiative with the goal of establishing greater connectivity between Asia, Europe and Africa. OBOR is supported in a number of ways, including by the Silk Road Fund, which is designed to promote the common development and prosperity of China and other countries and regions involved in the OBOR initiative. The fund was established in 2014 with investment from China's State Administration of Foreign Exchange, the China Investment Corporation, the Export-Import Bank of China and the China Development Bank. With an initial capital investment of USD 10 billion, the fund has grown to USD 40 billion and is dedicated to the development of China and the other countries and regions involved in the OBOR initiative. The USD 1.65 billion Karot Hydropower Project in Pakistan was chosen as the first Silk Road Fund investment project (Smith, 2015).

The China-Pakistan Economic Corridor (CPEC) and the Bangladesh-China-India-Myanmar (BCIM) Economic Corridor also are closely related to the OBOR initiative. The CPEC is a collection of ongoing projects with Chinese investment to expand and enhance Pakistan's infrastructure, involving a variety of sectors including energy, roads and railways. China will provide about USD 46 billion of investment in Pakistan through the CPEC as per a bilateral agreement between the two countries (Government of Pakistan, 2016). Likewise, the BCIM Economic Corridor plans to build infrastructure, such as industrial zones, ports and roadways, to improve connectivity and facilitate trade in the region that stretches from China to Bangladesh, Myanmar and India (Deshmukh, 2015).

The AEC, TPP, RCEP, APEC and the Chinese-led initiatives, such as the AIIB and OBOR, are regional-integration advancements in Emerging Asia. While these initiatives have the potential to generate new trade and investment opportunities, reduce tariff and non-tariff barriers and improve regional infrastructure, care must be taken in the negotiations and implementation of these initiatives as the potentially divergent objectives of member countries could hinder ASEAN solidarity (Hamanaka, 2014). While increased regional integration is one of the best strategic responses to a changing global environment – by insulating the region from the global risks of a sluggish external environment, lower commodity prices and financial fragility – adequate policies

and regulations must first be in place to reap the benefits of regional integration. The next section will address the importance of public policy in facilitating regional integration and generating an environment conducive to business, investment and trade.

PUBLIC POLICY TO PROMOTE BUSINESS THROUGH REGIONAL INTEGRATION

Governments and multilateral institutions play a key role in strengthening regional integration and driving economic growth. This section outlines a series of policy reforms led by governments and regional institutions to support investment and trade, including in the areas of financial markets, infrastructure development and renewable energy.

Financial-market reforms

Financial-market reform can be strengthened to promote regional integration. For example, ASEAN has established a number of policies to develop financial markets within the region. At the same time, China also is implementing a number of economic reforms. While not a member of ASEAN, given the size of China's economy, improvements in Chinese financial markets will have important spillover effects for the surrounding region in areas such as trade and investment flows.

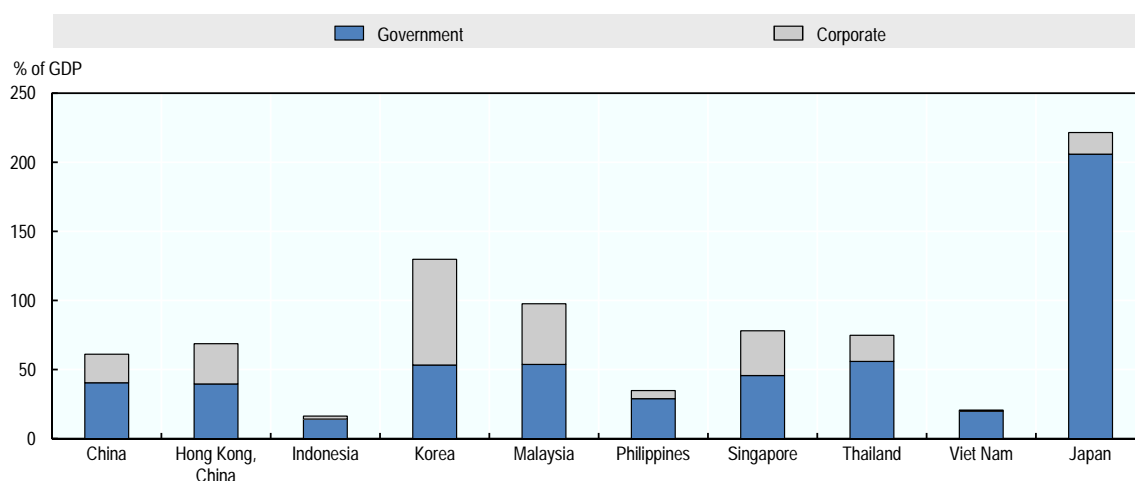
Developing the financial market through ASEAN-led initiatives

Two major financial initiatives are underway to develop financial markets in the ASEAN region: the ASEAN Infrastructure Fund (AIF) and the Asian Bond Markets Initiative (ABMI). The AIF was established by the ADB and ASEAN countries to address the region's infrastructure investment needs. The objective of the AIF is to finance projects that promote infrastructure development by mobilising regional savings, including foreign exchange reserves. All AIF-financed projects also are co-financed by the ADB. The ADB and ASEAN countries provided an initial equity of USD 485 million for the fund (ADB, 2016a). The AIF plans to provide a stream of USD 300 million in loans per year for regional infrastructure projects (APEC, 2015). By 2016, the AIF had financed seven projects in the amount of USD 300 million in Indonesia, Lao PDR, Myanmar and Viet Nam in the power, energy, water supply and sanitation, and transport sectors (ADB, 2016a).

The ABMI involves ASEAN+3 (ASEAN member states plus China, Japan, Korea) and aims to set up infrastructure and systems to promote greater market integration and capital flows. Key initiatives include establishing credit guarantee mechanisms, disseminating key information on national and regional bond markets and policies, facilitating demand for local currency denominated bonds and improving the regulatory framework for the bond market. The ABMI has supported investment in local currency denominated bonds, which can facilitate cross-border investment. In fact, issuance of local currency denominated bonds is growing faster than GDP in many of the economies participating in the ABMI (OECD, 2016b). Yet as Figure 1.4 depicts, bond markets are still underdeveloped, with the size of the region's bond market as a share of GDP averaging 65.4% in the first quarter of 2016, compared to Japan's at 221.4% (ADB, 2016c). In addition, growth in this market is dominated by government bonds, which accounted for 61.7% of the region's stock in March 2016 (ADB, 2016c).⁵ Further work is needed to improve regulatory restrictions and a weak financial infrastructure, which prevent bonds from becoming a viable

alternative to bank loans. A modernised legal framework, additional infrastructure for bond pricing and trading, and measures to attract domestic institutional investors in the bond market would help the region develop further (ADB, 2015).

Figure 1.4. Size and composition of local currency denominated bond markets in ASEAN+3



Note: ASEAN+3 refers to ASEAN member states plus China, India and Japan. Figure includes all ASEAN+3 countries with available data. Data refer to total outstanding local currency denominated bonds in the first quarter of 2016.

Source: ADB (2016b), *Asia Bond Monitor: June 2016*, www.asianbondsonline.adb.org/documents/abm_jun_2016.pdf.

Outside of the ASEAN region, public policy reforms within China too can improve the integration of Emerging Asia. Given the economic importance of China, its policies can have a large impact on the integration efforts for the surrounding region.

Economic reforms in China

China's growth rate is projected to slow down from 6.9% in 2015 to 6.4% in 2017 (OECD, 2016a), partly due to persistent industrial overcapacity and weak export growth. The Chinese government faces the difficult task of undertaking structural reforms while still avoiding a hard landing for the economy in the short term. China's transition is multifaceted, shifting from investment to consumption, from manufacturing to services, from public to private investment and from rural to urban (OECD, 2015b) as described below.

- **Investment to consumption:** Weak social security is one of the reasons behind China's high savings rate. To foster consumption, China is pushing for the expansion of social safety nets and reductions in import tariffs on consumer goods. The introduction of a minimum income standard and the steady increase of the minimum wage are evidence of some progress to date.
- **Manufacturing to services:** China is downsizing heavy industries and reducing regulatory restrictions on service sectors such as banking. The fastest-growing consumption areas are

related to education, healthcare and tourism. Further reforms would be needed to improve access to sectors where foreign investment is restricted, for instance in sectors such as energy, banking and telecommunications, where barriers to private and foreign investment had previously been high (OECD, 2015b).

- **Public to private investment:** China is restructuring state-owned enterprises (SOEs) as part of its efforts to shift the focus from public to private investment. To prevent SOE restructuring from affecting consumption, the government has limited reforms to the coal and steel sectors, which will be implemented over a time span of five years. The government also is offering fiscal support to mitigate the aftershocks of SOE reform, such as assistance for unemployment and help to companies that cut non-performing assets (Bloomberg, 2016).
- **Rural to urban:** Chinese society is making a transition from rural to urban. The government is granting residence permits to 13 million previously rural Chinese unregistered residents (Reuters, 2015). Further reforms will be required, such as the introduction of residence permits for migrant workers in the largest cities and improvement in rural education.

China has made great strides in implementing economic reforms. However, a number of policies still can be put into place to facilitate greater access to Chinese financial markets. Economic and financial reforms both in the ASEAN region and in China are crucial to ensuring an environment conducive to business. Financial initiatives such as the AIF and ABMI can promote regional integration and generate a favourable business environment. While economic reforms are a crucial element in regional integration, other elements such as infrastructure also must be addressed.

Promoting infrastructure investment

Infrastructure investment is an important element of regional integration efforts as it facilitates greater connectivity and market access. Policies to promote infrastructure investment include enhancing production networks and logistics and strengthening public-private partnerships (PPPs) for infrastructure projects.

ASEAN countries are in varying stages of development in terms of logistics and economic infrastructure (ERIA, 2010). The Economic Research Institute for ASEAN and East Asia (ERIA) categorises countries into three different groups depending on their degree of participation in production networks: those not likely to join in the near future, those intending to participate and those already in production networks. Not one East Asia country falls into the first category; rather regions of countries, such as the mountainous areas of Mekong, the islands of eastern Indonesia and the Southern Philippines, are amongst those falling into this tier. Cambodia, Lao PDR and Myanmar (CLM) fall into the second category. Indonesia, the Philippines, Viet Nam, Singapore, Thailand and Malaysia are in the third category.

Development strategies vary depending on a nation's level of development. The CLM countries are aiming to integrate into production networks through simple industries, such as textiles, garments, electronic parts or equipment manufacturing. Countries that are already integrated into global value chains (GVCs) are focused on stepping up from middle-income to developed economies. The strategy of Indonesia, the Philippines and Viet Nam is to form industrial agglomerations and further develop through technological innovation. Meanwhile, the strategy of

Singapore, Thailand and Malaysia is to create innovation hubs and focus on attracting skilled labour.

The high cost of logistics remains a common challenge in the region, regardless of the country's stage of development. According to the World Bank's Logistics Performance Index (LPI) – an indicator of the efficiency of global supply chains coded from 1 (worst) to 5 (best) – the average LPI score of ASEAN countries in 2016 was 2.99, while the highest scoring country was Germany at 4.23 and the lowest was Syria at 1.6 (World Bank, 2016c). This shows that ASEAN countries have room to improve. In fact, logistics represent more than 15% of total supply chain cost in Thailand, 14% in Malaysia and 13% in Indonesia (Coia, 2013). Better infrastructure and regulations can lower logistics costs. A good example is the Philippines, where restrictions that prevented foreign shipping companies from serving domestic routes were abolished in 2015 to remove competition constraints and promote greater efficiency (OECD, 2016d).

Strengthening PPPs for infrastructure

Governments are making efforts to strengthen PPPs for infrastructure development. The Philippines, Indonesia and India have attempted various reforms to encourage PPPs (OECD, 2016b). Key advantages of a PPP for infrastructure projects include the incorporation of private sector expertise in the design and operation of a project, and the ability to provide the service in a more efficient manner (OECD, 2012). The private sector, however, can still face difficulties in raising large amounts of project finance.

One solution to this problem is viability gap funding (VGF), whereby the government supports infrastructure projects that are economically justified but fall short of financial viability. For instance, long payback periods or user charges that fall below commercial levels can affect the financial viability of a project. Through VGF, the government contributes capital as a shareholder to show long-term commitment and reduce the total project cost. Indonesia and India are amongst the countries that use VGF; and the Indian government, for instance, approved VGF for solar power projects in early 2016 (Business Standard, 2016).

Another way in which governments can facilitate PPPs is to guarantee infrastructure projects against potential losses. In 2009, for example, the Indonesian Infrastructure Guarantee Fund (IIGF) was established to provide government guarantees to leverage private infrastructure financing. This fund of USD 1.5 billion in capital aims to enhance the bankability of PPP projects for a broader base of investors (Roesly, 2013). Meanwhile, multilateral organisations such as the ADB provide guarantees to support infrastructure projects, financial institutions, capital market investors and trade financiers, covering both credit and political risks (ADB, 2016c).

Infrastructure investment is an essential element of enhanced regional integration. By investing in infrastructure, connectivity can be increased at the regional scale, providing an environment more favourable to business. Renewable energy is one specific infrastructure area that can help to green the energy mix and can benefit from increased regional integration.

Public policy supporting investments in renewable energy

Renewable sources make up a considerable portion of the energy mix in Emerging Asia and renewable energy capacity is expected to increase. More than 24% of China's power capacity was generated by renewable sources in 2015 compared to almost 16% in the Asia and Pacific region (excluding China) (IEA, 2016). China is the largest renewable energy market in the world. According to the International Energy Agency (IEA), total renewable energy capacity⁶ is expected to increase by roughly 60% in China with 305 gigawatts (GW) added from 2015-21. India's current capacity will double to reach 160 GW over the same period (OECD/IEA, 2016).

Public policies and international co-operation play a key role in supporting growth in renewable energy by providing targeted support as well as reducing support for fossil-fuel energy sources. Prior to the 21st United Nations Conference of the Parties (COP21) and the Paris Agreement on climate change, governments played a key role in giving incentives to the private sector to foster greater investments in renewables and accelerate the phasing out of high-carbon energy sources.

The commitments by China to install 200 GW of wind power and 100 GW of solar photovoltaic (PV) power by 2020 and by India for 100 GW of solar PV power by 2022 are examples of government support for renewables (IEA, 2015). In the case of India, ambitious commitments in 2015 represent a fivefold increase from the target set in 2010 to reach 20 GW of installed solar energy by 2020. At COP21, India and France also launched an International Solar Alliance of 120 countries with the goal of investing in one terawatt of additional solar power capacity by 2030 (UNFCCC, 2015).

Governments are taking action to reduce subsidies for fossil fuels. Due in part to market fluctuations and lower oil prices, countries like India, Malaysia and Indonesia have embarked on programmes to reform fossil-fuel subsidies (IEA, 2015). India, for instance, abolished diesel subsidies in October 2014 after having implemented gasoline reforms in 2010 (IEA, 2015). Malaysia increased electricity tariffs by an average of 15% in January 2014 and eliminated gasoline and diesel subsidies in May 2014 (IEA, 2015). Indonesia stopped subsidies to gasoline and capped the diesel subsidy in January 2015 (IEA, 2015). Efforts to reduce fossil-fuel subsidies help to level the playing field for renewable energy producers.

Finally, enhanced regional co-operation in generation and distribution can further facilitate the expansion of renewable energy. ASEAN, for example, has made energy a key area for co-operation. The ASEAN Plan of Action for Energy Cooperation (APAEC) includes initiatives such as the ASEAN Power Grid and projects like the Trans-ASEAN Gas Pipeline. In the area of renewable energy, the "aspirational target" is to increase the share of renewables in the energy mix to 23% by 2015 (Zamora et al., 2015). Hydropower projects on the Mekong River are another area where enhanced regional ties can support future generation of renewable energy that can be exported throughout the region (OECD, 2016b).

By undertaking policy reforms in financial markets, infrastructure investment and energy markets, governments can enhance regional integration, which will produce an environment conducive to business. While regional integration efforts and policies are still shifting and evolving, this is an opportune moment to incorporate the views of the private sector into the development of regional integration initiatives. Accordingly, the next section provides private sector insights regarding increased regional integration in Asia.

PRIVATE SECTOR INSIGHTS ON EXPANDING BUSINESS THROUGH REGIONAL INTEGRATION

This section includes insights on regional integration in Asia drawn from the EMnet Asia meeting held in Paris at the OECD headquarters on 8 March 2016. It provides an overview of policy areas mentioned by the private sector as key for improving the region's investment climate, such as logistics and GVCs, infrastructure, the labour market and talent retention, finance, energy, innovation and SMEs. The private sector is particularly focused on the implications of China's slowdown and the business opportunities generated by higher regional integration.

Sectoral views on regional integration

Logistics and GVCs: ASEAN firms should capture higher parts of global value chains by owning brand names and technology

Participants stressed the importance for Asian companies to get a higher part of the value chain through proprietary brand names and technologies. The participation of Southeast Asian and East Asian economies in GVCs increased from 43% in 2001 to 49% in 2011 (OECD and World Bank, 2015). However, ASEAN companies participate primarily in GVCs by contributing small components that generate employment but are limited to a marginal portion of the overall value chain. For instance, approximately 59% of the value of the iPhone has been captured by the United States, while the rest of the value is dispersed amongst Korea, China and the rest of the world (Kraemer, Linden and Dedrick, 2011). To get a higher part of the value chain, it is essential to own the brand name and technology, which can be acquired through technology transfer or M&As. A prime example is the Tata Group, which owns 70 brands in sectors such as automotive, financial, food and beverage, hotels and realty, products, retail, and services. Since 2000, the Tata Group has diversified its business and brand portfolio through approximately 80 M&As. Participants proposed that a group of "ASEAN multinationals" that hold their own brand names and can produce higher value goods and services should be nurtured in Asia to move higher up in the value chain.

Infrastructure: Financially viable projects are crucial to channelling capital into infrastructure investments

Infrastructure financing can channel the region's available funds to viable and sustainable projects. The region has abundant capital in the form of foreign exchange reserves and savings. In the ASEAN region, foreign exchange reserves totalled approximately USD 700 billion in 2016 (IMF, 2016), and the average savings rate was 33% of GDP in 2014 (World Bank, 2016c). The key is to set up a framework for investors to make a proper risk assessment and distribute funds to infrastructure projects that are the most viable and sustainable. To improve the framework for private investment in infrastructure, special funds have been established in the Philippines to facilitate the preparation and financing of PPPs as a mechanism for risk sharing; these include the Strategic Support Fund, the Project Development and Monitoring Facility, and the Philippine Infrastructure Development Fund (OECD, 2016d). Meanwhile, Mahindra World City in Chennai, India has become the blueprint of the Smart Cities Mission, India's plan to develop 100 smart

cities (see Box 1.1). Mahindra World City is built on the model of sustainable urbanisation and integrates offices, residences and schools.

Box 1.1. India's Smart Cities Mission

The Smart Cities Mission is an Indian government initiative to develop 100 sustainable cities between 2015 and 2020. The Smart Cities Mission seeks to boost economic growth and enhance quality of life by using technology, information and data to improve infrastructure and services. The Indian Cabinet approved USD 15 billion to develop 100 smart cities and rejuvenate 500 others. The first 20 smart cities to be developed were announced in January 2016. The Smart Cities Mission will provide investment opportunities for the private sector to partner with the Indian government in sectors such as manufacturing, logistics, tourism and services.

Source: Smart Cities Mission, Ministry of Urban Development, Government of India website, <http://smartcities.gov.in/> (accessed 18 April 2016)

Some of the main barriers to infrastructure development identified by participants were underdeveloped financial systems, significant upfront costs for long-term investment and the absence of financially viable and well-designed infrastructure projects. Participants stressed that financial systems are largely bank-dominated, with commercial banks accounting for more than 82% of total financial assets in the ASEAN region (ADB, 2013). Furthermore, most banks in the ASEAN region are small, with an average size of bank assets equivalent to 126% of GDP (ADB, 2015). The corresponding figure for an advanced Asian economy like Japan is 378% (ADB, 2015). Non-bank financial institutions are not well-developed, which is exemplified by the fact that the size of the ASEAN region's insurance sector as a percentage of GDP is not even half the average of advanced economies (Global Counsel, 2015). In India, banks have played a crucial role in infrastructure financing but the corporate bond market is still underdeveloped (Reserve Bank of India, 2015).

Large upfront costs are another constraint for long-term private infrastructure investment (OECD, 2016c). In the ASEAN region, prudential regulations, which are designed to protect banking systems from failure, discourage banks from extending long-term credit. In India, financial institutions are strained due to increasing levels of stressed assets in the infrastructure sector. For example, infrastructure loans, which made up 15% of total bank loans, represented 30% of total stressed loans in 2015 (Reserve Bank of India, 2015). Participants pointed out that this was because companies are required to commit large amounts of money in the initial stages of infrastructure projects. A proposed solution to reduce risks for the private sector calls on the government to fund projects initially and roll in public-private financing at a later point in time. This requires caution, however, as excessive risk taken on by the government has led to a number of failed PPPs in infrastructure in countries such as the Philippines (OECD, 2016e).

Participants also pointed out the absence of financially viable and well-designed projects for the private sector. Participants highlighted the private sector's interest in these types of projects. OECD analysis shows the negative impact of limited or restricted private capital flows on both infrastructure and non-infrastructure business investments (Blundell-Wignall and Roulet, 2015). Initiatives such as the Indonesian government's 2011 Master Plan for Acceleration and Expansion

of Indonesian Economic Development 2011-25 (MP3EI) recognise the important role played by the private sector in economic development (OECD, 2015a). With the MP3EI, the Indonesian government hopes to lower regulatory barriers to investment and increase co-operation between the public and private sectors (WTO, 2013).

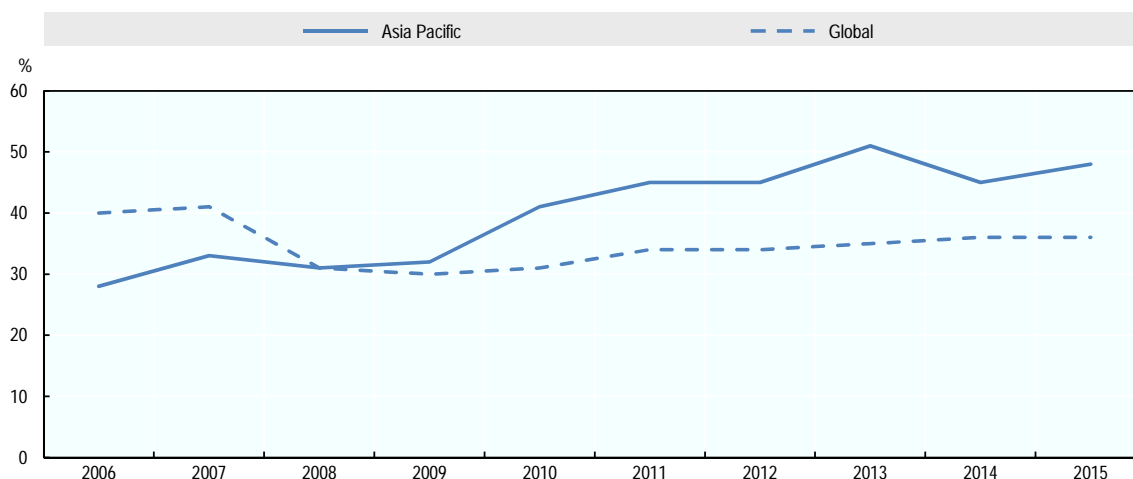
Beyond such initiatives, it is important for governments to maintain the principle of competitive neutrality to secure the private sector's inclusion. This occurs when no entity operating in an economic market is subject to undue competitive advantages or disadvantages (OECD, 2012). The ensuing business environment is one where goods and services are produced by those who do so most efficiently.

The labour market and talent retention: Companies struggle to find talent due to talent emigration, language barriers and lack of soft skills

The private sector faces many difficulties in the labour market despite efforts to facilitate freer flow of skilled labour within the ASEAN region. ASEAN Mutual Recognition Arrangements allow professionals in key sectors – such as doctors, dentists, nurses, architects, engineers, accountants, surveyors, and tourism professionals – to work more easily in ASEAN countries (ASEAN, n.d.). Progress has been slow. Participants point to a range of challenges including labour cost volatility, labour relations challenges, local talent shortages, and a lack of soft skills and English language skills.

The share of employers reporting talent shortages in Asia-Pacific was 48% in 2015, higher than the global average of 38% (Figure 1.5) (ManpowerGroup, 2015). Indian companies outside of the IT industry have experienced difficulties in hiring engineers due to a rush of talent towards the IT industry. In China, the success of Internet enterprises such as the Alibaba Group as well as government support in the form, for instance, of university parks and technology business incubators have attracted local talent towards entrepreneurship rather than traditional employment. In fact, China has a high percentage of young entrepreneurs, with 57% of entrepreneurs in the 18 to 34 age group (Global Entrepreneurship Research Association, 2012). In Thailand, companies have found it difficult to attract locals into manufacturing as the country is driven by agriculture. Lack of soft skills and talent migration to Singapore have been key challenges faced by the private sector in Malaysia. The private sector is working with universities and governments to address the talent crunch and to develop soft skills. Business organisations also are making efforts to work closely with university networks.

Figure 1.5. Percentage of employers with difficulties filling jobs



Note: Asia-Pacific includes responses from more than 7 700 hiring managers in Australia, China, Hong Kong (China), India, Japan, New Zealand, Singapore and Chinese Taipei.
 Source: ManpowerGroup (2015), *Talent Shortage Survey*,
www.manpowergroup.com/wps/wcm/connect/db23c560-08b6-485f-9bf6-f5f38a43c76a/2015_Talent_Shortage_Survey_US-lo_res.pdf?MOD=AJPERES.

Finance: Risks and rewards of financial integration

Participants broadly agreed that financial integration was critical to diversifying financial resources, lowering the cost of financing and triggering integration in the industrial sector. Participants noted that financial integration would facilitate designing frameworks and tools to channel existing funds towards lucrative projects. They also noted that corporates are playing a limited but very important role in financial integration. For example, companies are investing in digital wallets, cross-border money transfer, rural financing, global depository receipts and payments banks.⁷

Concerns remain, however, on whether full integration is truly desirable, because large development gaps exist amongst the countries. For instance, the ABMI may succeed in expanding local currency bond markets in some countries, but it may generate further disparity with countries like Cambodia, Lao PDR and Myanmar, which have small or non-existent bond markets. Narrowing development gaps is essential for inclusive growth. Existing initiatives are working to reduce development disparities. In particular, the Initiative for ASEAN Integration (IAI) was launched in 2000 to narrow the development gaps between ASEAN-6 (Brunei Darussalam, Indonesia, Malaysia, Philippines, Singapore, Thailand) and CLMV countries (Cambodia, Lao PDR, Myanmar and Viet Nam). The IAI is now in its third work plan (2016-20), and has narrowed its scope and increased its focus on improving implementation capacities. Work Plan III targets five strategic areas, notably food and agriculture, trade facilitation, micro-, small- and medium-sized enterprises (MSMEs), education, and health and wellbeing (OECD, 2017). Although the IAI has many action lines, overall progress has been limited and the level of implementation has remained very low (OECD, 2016b).

Otherwise, participants highlighted that although China's financial integration in the global economy is still low, it is becoming greater. Since the beginning of October 2016, for instance, the renminbi has been included in the International Monetary Fund (IMF) Special Drawing Rights (SDRs). SDRs are an international reserve asset set up by the IMF that can be exchanged into currencies. The value of the SDR is currently based on a basket of four currencies: the US dollar, the euro, the Japanese yen, and the British pound.

Energy: The region is expected to shift further to renewable energies as their competitiveness improves and they are supported by favourable government policies

Asia is emerging as a key market for renewable energy development driven by China and India. Significant regional investment in renewable energy is occurring, and enhanced regional integration could further stimulate investment. Indeed, investment is increasing and strong commitments by national governments to renewables have been facilitated by a variety of entities. What also helps are actions taken by regional groups and platforms like ASEAN, COP21 and the Group of Twenty (G20), which are expected to continue driving future investment. China is the largest global investor in renewable power, having invested USD 103 billion in 2015 or 35% of world investments (FS-UNEP, UNEP and BNEF, 2016). In some regions of India, for example, solar PV has become more cost-effective than conventional energy such as coal (Box 1.2).

The case of India and China demonstrate that renewables can be used as an industrial development policy, much in the same way as fossil fuels were used for industrialisation in the past 200 years. China and India have begun to include renewables as part of the industrialisation process – as a tool to generate employment, enhance energy security and reduce balance of payments burdens (Matthews, 2016).

Box 1.2. Solar power and FDI: Market and policy convergence in India

Important policies to increase FDI inflows to India have been announced by the Modi government, including the “Make in India” initiative, which has a range of support measures for the deployment and development of renewable power in the country. The government is seeking to attract investors particularly for solar energy by providing a range of financial support instruments including energy subsidies, duty exemptions, guarantee schemes, loans at concessional rates and special incentives for all renewable energy technologies exported from India.

From a market dynamics perspective, solar PV has become increasingly cost-competitive over the years in certain regions of India. This is because investments in renewable energy drive down the cost of its production, expanding the market for its adoption and making further investment more attractive. For example, Solairedirect, an Engie subsidiary, won 140 megawatts (MW) in solar projects in the state of Rajasthan with an offer of INR 4.35 (Indian rupees) per kilowatt-hour (KWh), compared to INR 4.65 for coal-fuelled power. Solar is becoming competitive in terms of project delivery (between tendering and final commissioning). In addition, unlike mining, drilling or extraction, manufacturers benefit from learning curves that make production increasingly efficient and cost-effective. Solar PV facilities of up to 200 MW can now be delivered in 13 months, and such projects are becoming more attractive to international banks seeking to invest in India.

Source: Make in India website, Renewable Energy section, www.makeinindia.com/sector/renewable-energy; Sinha (n.d.), “Riding the Renewable Wave”, www.makeinindia.com/article/-/v/success-stories-of-make-in-india; Solairedirect (n.d.), “ENGIE Wins Solar Energy Project Bidding”, www.solairedirect.com/es/actualites/engie-wins-solar-energy-project-bidding-for-140-mw-in-india/ (accessed 13 July 2016); Matthews (2016), “Developing Countries and The Renewable Energy Revolution”, www.oecd.org/dev/developing-countries-and-the-renewable-energy-revolution.htm

Regulatory harmonisation: Greater regulatory harmonisation can help firms adapt more quickly to local contexts

Regulatory harmonisation can facilitate regional integration. “Glocalisation”, which takes into account both the global and local contexts when conducting business, is a rigorous and costly process of adapting to local languages and regulations. Participants stressed that harmonisation of regulations through regional integration progress will reduce the costs of glocalisation significantly, since companies will be required to meet one standardised set of regulations in the region only rather than customising for each specific country.

SMEs: Sharing business knowledge, simplifying administrative processes and encouraging free movement of people can facilitate SME investments in Asia

Regional co-operation can play a role in encouraging investments by SMEs. Most large companies have operations in Asia, but SMEs tend to lack resources for international expansion. Sharing business knowledge, simplifying administrative processes and encouraging free movement of people will encourage SME growth. One example is the Make in India Mittelstand (MIIM) programme, which was initiated to facilitate German SMEs’ investment in India and entry into its market. MIIM offers a wide range of business support services, including strategy consulting, M&A advice, operational market entry support, tax and legal support, project financing, and the facilitation of approvals from central and state agencies. During the first six months, 42 German Mittelstand companies took part in the MIIM, 26 of which have announced concrete investment plans. The programme is expected to set up 15 new manufacturing plants, 6

expansion projects and two pilot projects covering the states of Maharashtra, Gujarat, Karnataka and Tamil Nadu (Embassy of India, 2015; Mittelstand 2015).

Implications of China's slowdown for business

China is a major part of the Asian economy; it is the largest contributor to FDI outflows and the second largest host economy to FDI inflows in developing Asia (UNCTAD, 2016). China's development and growth will influence the region in both the public and private sectors. Accordingly, the private sector has highlighted a number of business implications of a Chinese slowdown.

China's slowdown should be understood in terms of its two-tier economy

Participants stressed the importance of understanding the nature of China's slowdown. The country is a two-tier economy. According to the National Bureau of Statistics of China (2015), in 2015 primary, secondary and tertiary industries made up 9%, 41% and 50% of GDP, respectively. The two tiers of China's economy refer to the secondary and tertiary sectors. One half of China is the "old" economy, namely the secondary or industrial sector, which includes manufacturing, mining and construction. This sector is undergoing a hard landing, with year-on-year nominal growth close to 0% in 2015 (Siepmann, 2015). The other half of China's economy is the "new" economy, or the tertiary sector, which includes services and retail. This sector has experienced strong growth. For example, year-on-year nominal growth of tertiary industries reached nearly 12% in the third quarter of 2015 (Siepmann, 2015). In other words, it was the tertiary sector that drove China's total growth in 2015.

China is transitioning towards a new growth model. The old economy, however, is what has the most direct implications for the rest of the world, especially commodity exporters. China's structural reforms are generating uncertainty in the rest of the region. SOE reform is particularly important to improve efficiency, manage non-performing debt and reduce excess labour. If successful, China may be able to increase potential growth and improve productivity in the long run. Participants agreed that China's transition may be painful for the rest of the world in the short term; however, it has the potential to bring long-term benefits to the global economy.

China's slowdown is impacting its neighbours through six main channels

The implications for and impact of China's slowdown on other countries depend on the structure of the country's economy and its ability to take advantage of opportunities and minimise risks. China's neighbours are affected through six main channels, namely export demand, commodity prices, labour costs, exchange rates, FDI and cost of capital.

- **Exports:** Many developing Asian countries have depended on the Chinese market to export commodities. As China restructures from "hard" sectors to the service sector, these countries are being impacted negatively.
- **Commodity prices:** With lower prices and less demand, commodity exporters have been hit hard by China's slowdown. Lower prices can benefit countries that depend on imports and open opportunities for large commodity importers, such as India.

- **Labour costs:** Labour costs are rising in some sectors as a consequence of the current economic transition. Countries that are able to enhance competitiveness in these sectors can benefit from the Chinese slowdown.
- **Exchange rates:** The Yuan renminbi fell nearly 5% against the US dollar in 2015 (Financial Times, 2016). Asian currencies face downward pressure due to their significant economic interdependencies (OECD, 2016e). Further impact will depend on whether devaluation continues and on other countries' policy responses to remain competitive.
- **Outward Chinese FDI:** Despite the slowdown, China will continue to invest in natural resource extraction. Although overall investment volumes may decline, countries can still benefit from Chinese demand for commodities.
- **Cost of capital:** China has been a net capital exporter, which has contributed to low global interest rates. In other words, a large supply of savings originating from China has contributed to low global interest rates (Zhao, 2016).

China's transition is an opportunity for economies to strengthen domestic-led growth

Participants speculated that China's slowdown has resulted from the unsustainability of rapid economic growth based on the expansion of low value-added sectors. China has begun to phase out labour-intensive sectors and move into high-tech, high-value sectors. Beyond that, moving into knowledge-based industries, promoting service sectors, increasing productivity and improving tertiary education are key elements for the development of its internal markets. For other Asian economies, China's transition represents an opportunity to restructure their economy and encourage a shift from export-led to domestic-led growth. It also should push commodity-oriented countries, which cannot rapidly shift to domestic-led growth, to search for new markets.

Chinese overcapacity and low commodity prices provide low-cost procurement opportunities

Commodity importers in Asia can leverage China's overcapacity to source raw materials at a low cost. China produces eight to ten times more steel, aluminium, tyres and batteries than India. India and China, for example, produced 86.5 and 823 million tonnes of crude steel, respectively, out of a total global production of 1 665 million tonnes in 2014 (World Steel Association, 2015). Companies can benefit from low commodity prices and Chinese overcapacity to procure raw materials from China at lower costs.

China influences the rest of the ASEAN region in terms of the investment climate and the subsequent success of various regional integration initiatives. While progress has been made on regional integration, many challenges remain that need to be addressed moving forward. The private sector highlighted a number of prospects and challenges for current regional integration initiatives.

Prospects and challenges for regional agreements

While there are a number of promising regional agreements in Emerging Asia, the private sector also highlighted a number of challenges that could threaten the success of those integration efforts. These include economic gaps, non-tariff barriers and restrictive services policies. While these gaps, along with the uncertainty generated by the multiplication of trade

agreements, can delay business decision making, the private sector is developing business models to work through these issues.

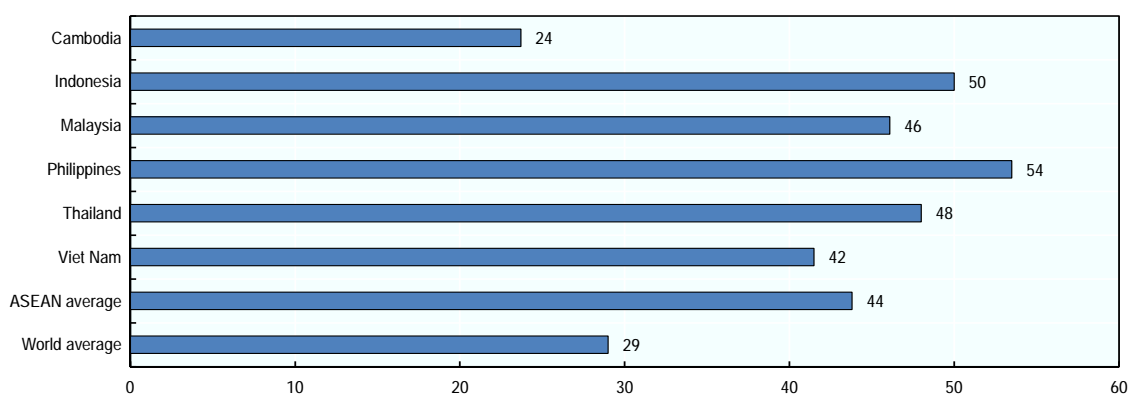
The AEC still faces economic gaps, non-tariff barriers and restrictive services policies

While the aim of the AEC is to move towards a single market and production base, participants pointed to the challenge of the remaining economic gaps amongst ASEAN members. The disparities amongst ASEAN economies are significant and complex. Challenges for economic integration include the fact that per capita income levels in 2014 varied widely from USD 78 958 in Singapore to 3 093 in Cambodia (OECD, 2016b).

Participants also expressed concerns that non-tariff barriers are emerging as new protective measures. Intra-regional tariffs have fallen rapidly in the last decade to 0.5% in 2014 (OECD, 2016b). Non-tariff barriers remain, however, including anti-dumping regulations as well as constraints related to logistics, transport, infrastructure problems and weak institutions. Finally, ASEAN has highly restrictive trade-services policies. Its average score on the Services Trade Restrictions Index (STRI) is 52% higher than the global average (Figure 1.6).⁸ Participants stressed that domestic regulations should be changed to further liberalise trade in services.

Figure 1.6. Overall Services Trade Restrictiveness Index in ASEAN, 2008-11

Index, higher value indicates more restrictive policy measures



Note: ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Thailand and Viet Nam.

Source: World Bank Services Trade Restrictions database (Borchert, Gootiiz and Mattoo; 2012a and 2012b), cited in OECD (2016b), *Economic Outlook for Southeast Asia, China and India 2016*, <http://dx.doi.org/10.1787/saao-2016-en>.

A multiplication of trade agreements has brought about uncertainty in business decision making

The private sector is finding it difficult to determine where to invest and how to position themselves best in the context of multiple ongoing regional integration processes and signs of increased protectionism. Participants noted that the TPP addresses new trade challenges, such as the digital economy, SOEs and intellectual property rights. The open-ended approach of the TPP also was considered a positive aspect to engage more members in the future. China's

absence, however, raised questions from private sector participants about the TPP's comprehensiveness. Requirements for regulatory convergence in intellectual property rights, SOEs and competition also have made some ASEAN members reluctant to join the TPP. Otherwise, some participants were of the opinion that the RCEP, rather than the TPP, should be the business world's priority. They pointed out that RCEP could be more relevant in the short term, since the final rounds of RCEP negotiations could conclude in 2017, while ratification of the TPP will take several years. The role of the United States in the TPP presents additional uncertainty. In January 2017, the United States withdrew as a signatory of the TPP and pledged to stop participation in TPP negotiations via a presidential memorandum (White House, 2017). In addition, the RCEP could be a stronger tool for ASEAN members to secure their interests owing to ASEAN's strong role in the agreement. As the parties of the RCEP are the ten member states of ASEAN and six of ASEAN's free trade partners, ASEAN plays a central role in the negotiations and can have a stronger voice.

Companies are changing their business models as a consequence of higher trade integration

In the interim period of uncertainty caused by ongoing agreements, companies have begun to use trade integration facilities to gain a competitive edge. In India, free trade agreements can sometimes produce an inverted duty structure, where the import duty for raw materials is higher than the import duty for the finished product. This has an adverse effect on manufacturers as it becomes cheaper to import a finished product than to manufacture it domestically. Companies are finding ways to work around these constraints. In particular, they can devise solutions within the framework of existing trade agreements to leverage the supply chain and gain competitiveness in the market. Participants in the EMnet meeting mentioned the example of an Indian manufacturer leveraging the existence of bilateral trade agreements between China and Thailand to supply zero-duty inputs from China to Thailand, where the Indian manufacturer makes the final product. The product is then shipped to India to be sold in the local market at a lower price than that of competitors. These strategies are unlikely to support local manufacturing or substantial employment and reflect the pragmatic approach that some companies are taking.

While the slowdown of the Chinese economy will influence the region for both the public and private sectors, increased regional integration offers a way forward for ASEAN in the face of global economic uncertainty. Although regional ties have been enhanced significantly since the 1980s, additional policy efforts are required to fully achieve integration targets. Countries in the region need to make additional efforts and take active steps to realise a single economic market and promote economic integration.

CONCLUSION

Enhanced regional ties can generate significant opportunities for the private sector. Even in the context of a Chinese slowdown, enhanced regional ties in Asia can still generate significant opportunities for private-sector growth. In particular, the AEC has the potential to support higher trade and investment in the region. Amidst the various regional co-operation efforts underway, companies are capitalising on existing regional and bilateral trade agreements.

Challenges remain, however, particularly in areas such as trade in goods, trade in services, infrastructure and connectivity, and human and social development. The private sector highlighted these elements as critical for boosting regional integration in Asia and providing a favourable investment climate for inclusive growth and development. To facilitate regional integration further, policy makers could concentrate their efforts on reducing economic gaps and growth disparities, decreasing non-tariff barriers, and limiting restrictive services policies.

Notes

- ¹ ASEAN member states include Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic (hereafter "Lao PDR"), Malaysia, Myanmar, Philippines, Singapore, Thailand and Viet Nam.
- ² Unless otherwise noted, economic and financial data in this section are drawn from OECD (2017).
- ³ Unless otherwise noted, FDI data in this section is drawn from UNCTAD (2016). Emerging Asia includes ASEAN-10, China and India. Hong Kong (China) is considered separately.
- ⁴ Southeast Asia includes ASEAN-10 plus Timor-Leste.
- ⁵ The region refers to China, Hong Kong (China), Indonesia, Korea, Malaysia, the Philippines, Singapore, Thailand and Viet Nam.
- ⁶ Total renewable energy capacity includes capacity from bioenergy, hydropower, onshore and offshore wind, solar PV, concentrated solar power (CSP), geothermal and ocean technologies.
- ⁷ A digital wallet is an electronic device for electronic-commerce transactions using a smartphone; a global depository receipt is a certificate issued by a depository bank, which purchases shares of foreign companies and deposits it on the account; a payments bank is a basic banking service for people without bank accounts.
- ⁸ STRI helps identify which policy measures restrict trade, provides policy makers and negotiators with information and measurement tools to open up international trade in services, and negotiate international trade agreements.

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contact the Secretariat:**

dev.emnet@oecd.org

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