

# Economic Insight: South East Asia

Quarterly briefing Q2 2016



Welcome to ICAEW's *Economic Insight: South East Asia*, a quarterly forecast for the region prepared specifically for the finance profession. Produced with Oxford Economics, one of the world's foremost independent global advisory firms, it provides a unique perspective on the prospects for South East Asia over the coming years. We focus on the largest economies of the Association of South East Asian Nations (ASEAN) – namely Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

## Sustaining productivity growth key to prosperity

In this issue of *Economic Insight: South East Asia*, we assess recent productivity trends within the region, as well as some of the key structural drivers that underpin these developments.

- The ASEAN region has delivered an impressive productivity performance over the past couple of decades – average output per worker growing by three percentage points (pp) per annum. Within this, the region's lower-income economies have typically exhibited the fastest rates of productivity improvements, but ASEAN's high-income economies have also delivered impressive productivity performances by the standards of comparable economies elsewhere.
- This reflects a range of positive structural trends, including an ongoing shift from agriculture towards manufacturing and services, urbanisation and greater experience in the workforce. These factors should remain positive drivers in the coming five years.
- Despite strong foundations, the immediate outlook for the ASEAN region is more clouded. Although financial markets have rallied in recent weeks, this has not been matched by an improvement in economic conditions. Q1 data in China is turning out better than expected, but global trade remains weak, while lower oil prices continue to be a mixed blessing for the region.
- We expect external conditions to improve only gradually through 2016-17, while support from monetary and fiscal easing will be limited. We therefore forecast a very mild acceleration in overall GDP growth in the ASEAN-6 from 4.4% in 2015 to 4.5% in 2016 and 4.8% in 2017, compared to annual average growth of 5.2% between 2005 and 2015.

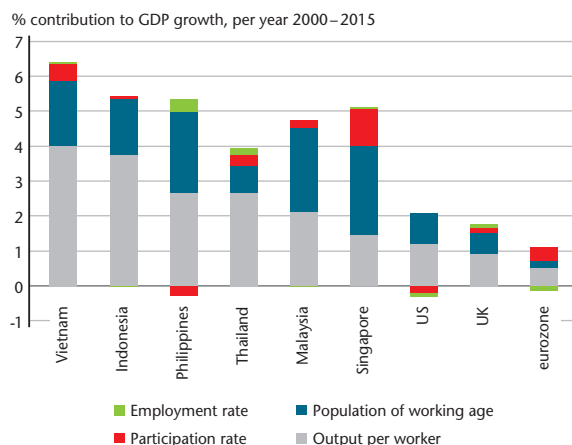
## An impressive track record of productivity

The ASEAN region has had an impressive productivity track record over the past couple of decades, with average output per worker rising 3% per year from

2000 to 2015, 2pp faster than Latin America and 1.4pp faster than Africa (albeit substantially slower than China, where output per worker has risen spectacularly by an average 9.1% per year over the same period).

Vietnam and Indonesia have been the top performers in terms of productivity growth, but even in Singapore where there is clearly less scope for 'catch-up' growth, output per worker has risen by 1.5pp per annum over this period. This comfortably outperforms other high-income economies: 0.3pp faster than the US, 0.9pp faster than the UK, and 1pp faster than the eurozone. Moreover, the region's economies have been able to deliver this productivity growth alongside robust growth in employment – a challenge not every part of the global economy has been able to match.

**Figure 1: Contributions to GDP growth**



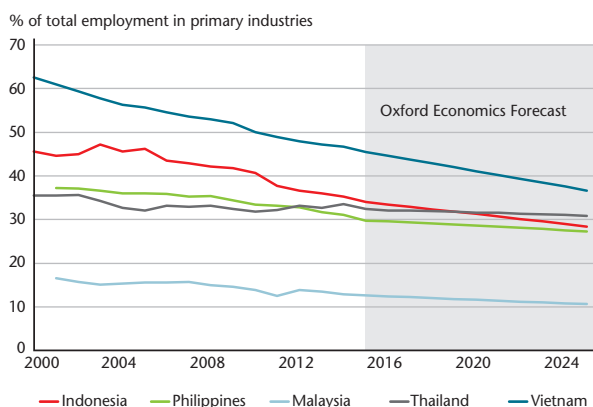
Source: Oxford Economics/Haver Analytics

### Sectoral shift one part of the story

Part of the region's success is of course due to the ongoing shift from agriculture to more capital-intensive sectors – either from a physical perspective (eg, manufacturing) or in human capital terms (service industries).

For example, the share of Vietnam's workforce employed in agriculture has fallen from 61% in 2000 to 44% in 2015. Other economies in the region have also benefitted from this shift away from agriculture in recent years, particularly Indonesia and the Philippines. However, this has had less impact in the region's higher-income economies, such as Malaysia and Singapore, which have made this shift in previous decades (Singapore is not included in Figure 2 due to a lack of data on employment in agriculture). By contrast, the agricultural workforce relative to total employment has been reasonably stable for some time in Thailand.

**Figure 2: Agricultural sector role in the economy**

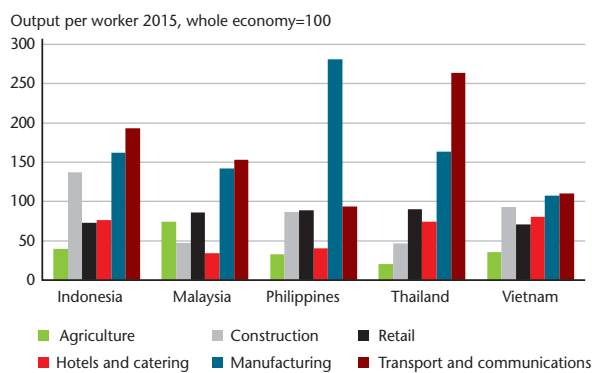


Source: Oxford Economics/Haver Analytics

Shifting workers to manufacturing industries and service sectors boosts productivity by increasing the degree to which capital is used alongside labour. Sectoral shift therefore increases the level of the worker's productivity. Furthermore, as technology has continued to evolve, productivity growth also typically tends to be faster in non-agricultural sectors. So there is both a level and a growth impact from switching workers between sectors. This finding is corroborated by Asian Development Bank research, which finds that agricultural productivity across ASEAN economies has typically risen by less than 2% per annum since 1970 – far slower than the comparable whole economy rate.<sup>1</sup>

Figure 3 sets out the average level of productivity in five key sectors across ASEAN economies. Even among relatively low value-added service sectors such as retail and hospitality, output per worker is typically two to three times higher than in agriculture, with this ratio increasing to 10-fold or more for countries with less productive agricultural sectors.

**Figure 3: Sectoral productivity vs agriculture**



Source: Oxford Economics/Haver Analytics

Productivity gains are, of course, even greater when employment shifts towards financial and business services, but in the interest of not grouping the other sectors too close together, these are not shown in Figure 3. In any case, these very highest value-added sectors still typically account for a small share of employment in most of the region's economies (ranging from 2% in Indonesia to 10% in Malaysia, although the share is much higher in advanced-economy Singapore).

**Figure 4: Contribution of sectoral shift to productivity**



Source: Oxford Economics/Haver Analytics

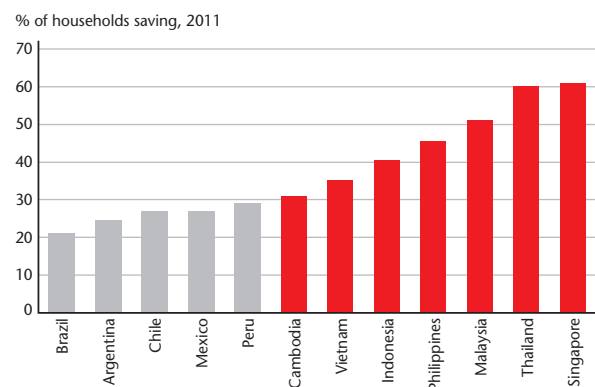
In Figure 4, we disaggregate whole-economy gains in output per worker into the contributions from sectoral shift and 'pure productivity' growth ie, improvements in productivity levels within sectors. For Vietnam, the two components have contributed in roughly equal

measures. Sectoral shift has been only marginally less important in Indonesia, and has made modest contributions in the Philippines and Thailand. For Singapore and Malaysia, the loss of lower value-added manufacturing sectors and redeployment of workers from these sectors into services is likely to be behind the very modest negative contribution from sectoral shift.

Of course, sectoral shift is not possible without a stable supply of finance with which to invest in both physical and human capital. Inward foreign direct investment (FDI) and other inward capital flows have a role to play in this respect. But the bulk of financing for business investment (and therefore diversification into new sectors with higher output per worker) must come from domestic savings and lending for economy-wide development to occur – particularly so among job-rich small and medium-sized enterprises. This is often described as the ‘virtuous cycle of saving and prosperity’.<sup>2</sup>

In this context, high household savings in the ASEAN region can help partly explain differences between its productivity performance and that seen in other ‘middle income’ regions. According to the World Bank’s *World Development Indicators*, 40–60% of households in ASEAN economies saved money during 2011, compared to 30% or below across Latin America (Figure 5).

**Figure 5: Household saving in ASEAN and Latin America**



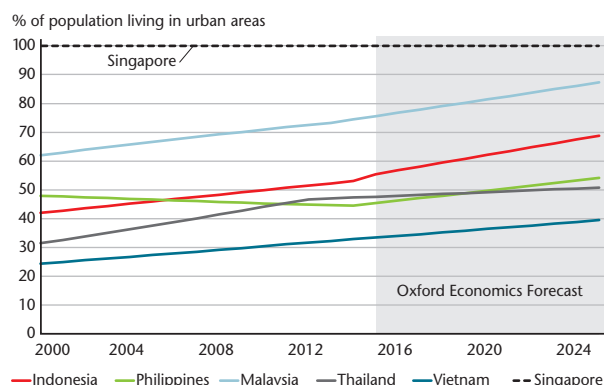
Source: Oxford Economics/Haver Analytics

### Urbanisation supports sectoral shift

Urbanisation has both supported and been driven by the sectoral shift. This reflects economic incentives to move to cities, but also boosts productivity in a number of ways, such as: making it easier to connect workers to technology; lowering firms’ transaction costs when serving their customers; and allowing ‘agglomeration’ effects such as the transfer of sector-specific knowledge between firms.<sup>3</sup>

Such a process has some way to go across much of the region and will continue to be a source to boost productivity. In Vietnam, Indonesia and Malaysia in particular, the proportion of residents living in urban areas is set to continue rising over the coming decade or so – an extra 7% of the population in Indonesia, 6% in Malaysia and 3% in Vietnam. This will support the shift into higher value-added manufacturing and services activities. However, urbanisation presents its own challenges and it will be important for governments to ensure urbanisation is well managed, with adequate provision of housing and public services, if it is to continue yielding gains to worker productivity.

**Figure 6: Urbanisation rate**



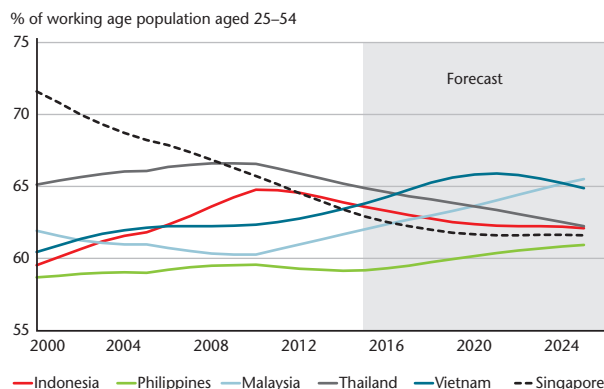
Source: Oxford Economics/Haver Analytics

### ‘Prime ageing’ workforce also supportive

One further factor that has supported productivity growth in some economies has been an increase in the working age population (ie, those aged 25–54). This age bracket (broadly speaking) is often referred to by labour economists as ‘prime age’ from the perspective of having greater experience and skill levels than younger workers, but less susceptibility to health problems or other barriers to work flexibility than older age groups. Data on wage distributions by age are relatively scarce in most ASEAN economies, but data from Singapore<sup>4</sup> illustrates that median monthly wages peak in the 35–39 and 40–44 age brackets, and are gradually lower for younger or older workers respectively. Average earnings among 25–29 year olds are more than 50% higher than in the 20–24 age group.

In Vietnam and Indonesia the ‘prime age’ share of the workforce has increased over the past 15 years (Figure 7). In other economies such as the Philippines, Thailand and Malaysia, demographic trends have been neutral in this respect. Yet in Singapore the workforce has been ageing relatively rapidly, drawing workers out of the prime age group and into older cohorts.

**Figure 7: Prime working-age population**



Source: UN/Haver Analytics

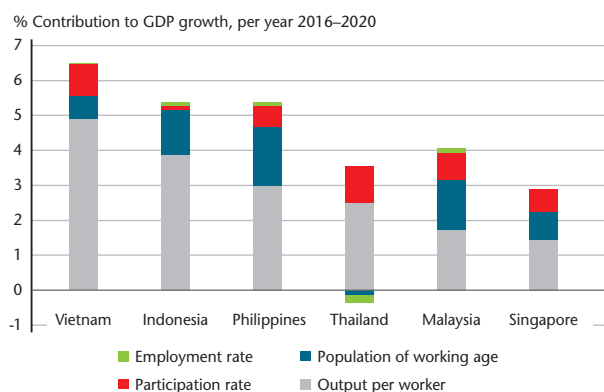
Looking ahead, Singapore’s prime age share is set to stabilise, easing the potential drag from ageing on productivity performance. Furthermore in Malaysia, the Philippines and Vietnam, share of workers in the prime age category will continue to rise for the coming decade or so. Of course, this will contribute more to productivity performance in economies that offer workers the most effective training and skills support, as well as providing the most business-friendly environment for job creation. We will pursue these themes further in the next edition of this report.



## Strong outlook for productivity growth ...

Overall, we are confident that the region's relatively strong productivity performance can be sustained in the second half of this decade. Plenty of scope for further sectoral shift, urbanisation and increases in the prime age share of the workforce should mean that Vietnam continues to deliver the region's strongest productivity growth, at just under 5% per annum, with Indonesia around 1pp slower (Figure 8). The region's highest income economies – Malaysia and Singapore – have the least scope for further sectoral shift though. Further, in Singapore's case, an already mature and urbanised workforce means these drivers contribute less than in lower-income ASEAN economies. Output per worker growth here should register around 1.5–2% per annum – a still relatively-impressive performance by the standards of other economies with similar levels of GDP per head around the world.

**Figure 8: Contributions to ASEAN GDP growth 2016–2020**



Source: Oxford Economics/Haver Analytics

## ... but near-term conditions remain weak

A relatively positive structural outlook for the ASEAN region is counterbalanced by a more mixed set of conditions in the immediate future. Equity markets in the region have rallied in recent weeks as investors' risk appetite has returned. This appears to have been helped by higher oil prices, a more dovish stance from the Federal Reserve and the announcement of additional stimulus measures in China and the eurozone.

There have also been signs that the downturn in China may be bottoming out, as the stimulus measures of recent months – including boosted credit growth, an easing of house purchase restrictions and expanded infrastructure spending – have spurred activity in the physical part of the economy. Growth of fixed asset investment in China picked up in Q1, partly because of a rebound in real estate construction, while new home prices rebounded nationwide in March for the first time in 13 months. Although China's overall GDP growth eased from 6.9% in 2015 to 6.7% year on year in Q1, this was a milder deceleration than many had feared until recently.

Given the importance of China as both a direct trading partner and a consumer of globally-traded commodities in which several ASEAN economies specialise, better domestic demand conditions in China have aided trade prospects across the region. Recent months have seen a modest upturn in Chinese import volumes, but growth remains much lower than the 2005–2013 period (Figure 9). Moreover, the broader global trade outlook has softened, with our forecasts for growth of goods import volumes in 2016 revised down in both the US and the eurozone. The prolonged slump in global

trade is therefore showing few signs of abating, which is continuing to weigh on growth prospects across the ASEAN economies. As such, the recent improvement in financial markets has not been matched by a similarly broad improvement in underlying economic growth dynamics.

**Figure 9: World trade and China's imports**

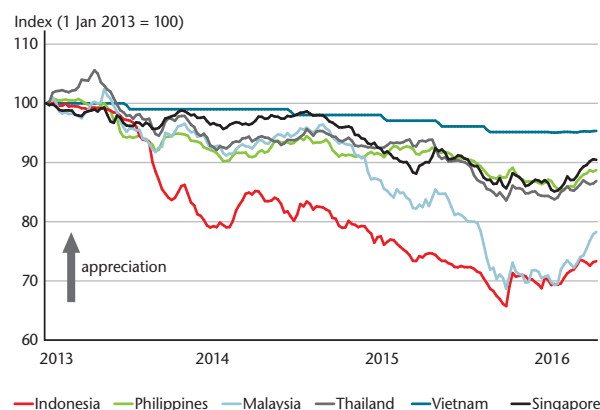


Source: Oxford Economics/Haver Analytics

## Should we expect more policy stimulus?

With growth below trend in many ASEAN countries and inflationary pressure very subdued, calls for policy easing remain strong. Central banks in Singapore and Indonesia have eased policy this year and we expect the majority of central banks in the region to maintain an easing bias.

**Figure 10: Exchange rates vs US\$**



Source: Oxford Economics/Haver Analytics

However, we believe that any additional monetary easing will be constrained by policy rates that are already approaching the 'zero lower bound' and/or the need to limit exchange rate depreciation (Figure 10). Indeed, currencies in the region may come under pressure again due to fragile domestic fundamentals and a backdrop of US rates edging higher. Even though market expectations of the pace of interest rate hikes in the US have been pared back recently, markets continue to expect that the next move by the Fed will be a tightening. As such, we expect that the easing cycle across South East Asia is close to an end, with only an additional 0.25–0.5 pp of rate cuts likely in countries where central banks are still cutting rates.

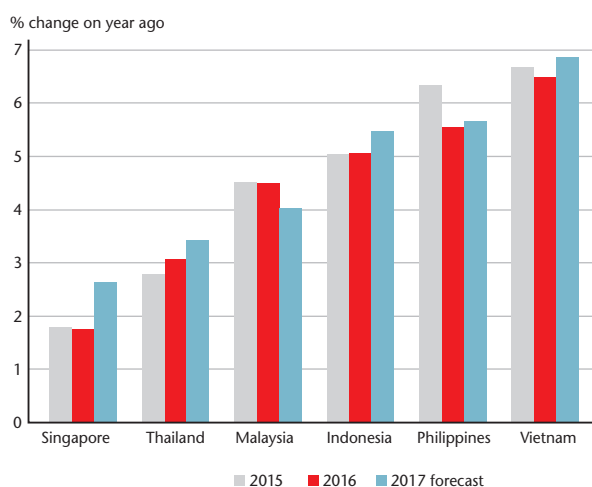
In light of the constraints on monetary policy, fiscal policy appears to be the main tool available to help boost domestic demand. But governments in the ASEAN-6 countries have traditionally been keen to preserve the health of their public finances, as reflected in their low

levels of public debt. Indeed, some countries in the region (notably, Malaysia and Vietnam) are currently planning fiscal consolidation measures. We therefore envisage only moderate use of countercyclical fiscal policy among the ASEAN-6 economies.

### Prospects for ASEAN economies, 2016–2017

Overall, we have become more cautious about the global outlook and this has contributed to downward revisions to our forecasts for GDP growth across the ASEAN-6 economies since our last report. With monetary and fiscal easing likely to be limited in scope, external developments are the main driver of the growth outlook. Although we do still expect global trade growth to pick up in coming months, the improvement will probably be gradual and patchy, meaning that it will support only a modest upturn in the region's economies.

Figure 11: ASEAN GDP growth



Source: Oxford Economics/Haver Analytics

Growth prospects continue to be brightest in Vietnam, as its wage competitiveness has enabled it to continue to attract FDI and to gain market share in labour-intensive industries despite the downturn in the region. We also expect robust growth in the Philippines and to a lesser extent, Indonesia, as their economies are supported by healthy domestic demand and strong macro fundamentals.

Malaysia is forecast to experience the most noticeable slowdown in economic growth among the ASEAN-6, as the lower oil price has resulted in a terms-of-trade shock and lower government revenues. Singapore and Thailand will also continue to struggle in the near term as their economies have been hit hard by both the prolonged downturn in global trade and their own structural problems (competitiveness in Singapore and chronic political uncertainty in Thailand).

### Recent economic news

Economic conditions have remained difficult this year for the economies of South East Asia due to the delayed recovery in global trade and lower oil prices. We therefore expect only a very mild acceleration in overall GDP growth in the ASEAN-6, from 4.4% in 2015 to 4.5% in 2016 and 4.8% in 2017.

Latest economic data in **Indonesia** has come in slightly better than expected, albeit challenges to growth persist. Financial conditions have also improved, with the rupiah having outperformed most other Asian currencies this year, bond yields having fallen and the stock market trending higher. Still, economic growth this year will remain constrained by the subdued external sector, which faces the backdrop of sluggish demand in Indonesia's major trading partners and the sustained fall in commodity prices.

**Malaysia** is regarded as one of Asia's success stories, but its vulnerabilities have been exposed in the current economic climate. The household sector remains under pressure from rising debt service costs and slower employment growth, while the outlook for private investment is subdued due to lower business confidence and higher borrowing costs. And the public finances are also under pressure from falling oil revenues. The government therefore needs to implement reforms to reignite growth if it is to achieve its goal of becoming a developed economy by 2020.

In the **Philippines**, latest indicators suggest that the solid momentum in domestic demand seen at the end of 2015 has continued into this year. We still expect GDP growth to accelerate in 2016, helped by a pickup in government spending and still-solid household consumption. Net exports are also likely to contribute to growth, as imports moderate after a strong 2015.

In **Singapore**, recent indicators have signalled a further deterioration in manufacturing conditions, underscoring the economy's reliance on the performance of the services sector this year. We expect services activity to remain firm on the back of an acceleration in government-related services and still robust household spending. Activity should rebound more solidly in 2017, in line with the broader recovery in global trade.

We expect economic growth in **Thailand** to pick up gradually this year and next, but the pace of expansion will remain well below that seen in 2010–2014. Activity has disappointed so far this year amid a difficult external environment, while political uncertainty continues to weigh on domestic activity. Still, tourism flows have proved resilient and public spending should maintain a strong upward trend.

Rising domestic demand and booming FDI are helping **Vietnam** to maintain economic growth at 6.5% in 2016, despite the difficult regional and global environment. Continued diversification of export industries from oil and coffee to textiles, electronics and other manufactures are also helping to shield the economy from the downturn in commodity prices.

## ENDNOTES

- 1 <http://www.adb.org/sites/default/files/publication/30380/ewp-363.pdf>
- 2 For a more in-depth analysis of the link between saving, investment, productivity and growth, see *Saving in Asia and Issues for Rebalancing Growth*, Asia Development Bank Working Paper Series, (May 2009).
- 3 For an extensive discussion of the link between urbanisation and productivity see *Urbanization and Growth: Setting the Context*, World Bank, (2009).
- 4 See Table 18 of *Labour Force in Singapore 2015*, Ministry of Manpower.

## Oxford Economics

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## For enquiries or additional information, please contact:

**Amy Tee, Head of Marketing, South East Asia**

T (+65) 9108 1517

E [amy.tee@icaew.com](mailto:amy.tee@icaew.com)

ICAEW  
9 Temasek Boulevard  
#09-01 Suntec Tower Two  
Singapore  
038989  
[icaew.com/southeastasia](http://icaew.com/southeastasia)

ICAEW  
Chartered Accountants' Hall  
Moorgate Place  
London  
EC2R 6EA UK  
[icaew.com](http://icaew.com)