Ravi Menon: Resilience, integration, opportunity – the ASEAN story

Opening address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Merrill Lynch Asian Stars Conference 2011, Singapore, 18 May 2011.

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Mr Brian Brille, Mr Peter MacDonald, Mr Richard McCormack, distinguished speakers, ladies and gentlemen, good morning.

Resurgence of Asia

1. According to estimates by the late British economist, Angus Maddison, two thousand years ago, India had the largest GDP in the world. China was close behind. Together, they accounted for more than half of global GDP. Asia ex Japan was 75 per cent of world GDP. And this was at the height of the Roman Empire in Europe, which accounted for just 10 per cent of global output. Over the next 1,800 years, the two Asian giants remained the largest economies in the world, with China pulling ahead of India about 500 years ago. For much of this period, Asia ex Japan was typically about three times larger than Western Europe.

2. Then came the Industrial Revolution in Europe. By the start of the First World War, Europe and America accounted for more than half of global GDP, with the combined share of India and China falling to less than 20 per cent. By 1950, the share of India and China fell to less than 10 per cent. Asia less Japan was only about 15 per cent.

3. Since then, the story has been of Asia's resurgence. By the end of the last century, Asia less Japan had doubled its share to 30 per cent of global GDP. China is already the second largest economy in the world, India the fourth largest, and you are all familiar with the various projections of when these two economies will become the largest and third largest respectively. The rest of Asia will continue to be the most buoyant region in the world, as it has been for the last 50 years.

4. The story of China and India as the new growth engines of the world has been told numerous times. I would therefore like to tell the story of the third growth engine of Asia – ASEAN.

The ASEAN value proposition

5. ASEAN is a two-trillion-dollar economy, the fifth largest in the world at purchasing power parity terms, ahead of Russia, Brazil, France and the United Kingdom. The external trade volume of the ASEAN-5 economies (Indonesia, Malaysia, Thailand, Philippines, Singapore) is more than three times that of India's total trade and about 60 percent that of China's. ASEAN provides good diversification for investors' Asian portfolios. Last year, foreign direct investments into the ASEAN-5 totaled nearly US$70 billion, roughly three times the inflows into India.

6. Let me touch on three aspects of the ASEAN story.

First, ASEAN is resilient: it rode the global financial crisis very well. I will assess how ASEAN is now coping with the post-crisis risks of inflation and capital inflows.

Second, ASEAN is getting more integrated. I will discuss the progress ASEAN is making towards a single market and production base, which will create a more seamless marketplace for businesses.

Third, ASEAN is opportunity. I will focus on the significant investment opportunities in ASEAN, especially in the area of infrastructure.

Resilience: managing inflation and capital inflows

7. Let me begin by touching on ASEAN's resilience in the face of external shocks. The Asian financial crisis of 1998/99 was a life-changing experience for many countries in the region. They were badly affected by the crisis and resolved never again to be so vulnerable. Macroeconomic policies have become more sound, financial regulation and supervision has tightened, national balance sheets strengthened, structural reforms stepped up, and corporate governance enhanced.

8. The ASEAN countries consequently showed remarkable resilience in the recent crisis. While credit tightened and trade plunged during the height of the crisis, there was no systemic financial fallout, especially in the banking industry. The region rebounded strongly, with the ASEAN-5 growing by 8 per cent in 2010. This year, growth is expected in the range of 5 to 6 per cent.

9. But strong growth has come with a new set of challenges. ASEAN and the rest of Asia are now grappling with rising inflation. Consumer prices are forecast to increase by 5.1 per cent in the ASEAN-5 this year, compared to 3.8 percent in 2010. Several factors underpin this.

10. First, elevated food prices. In the ASEAN-5 economies, food accounts for about a third of the consumption basket, much higher than advanced economies. Given this high weight of food, food price increases have a strong direct impact on headline inflation.

11. Second, strong inflows of capital adding to asset price and domestic demand pressures. Low interest rates in the advanced economies have prompted global investors to seek higher returns in emerging economies, especially in Asia.

12. Third, Asia's strong recovery from the crisis has led to high rates of capacity utilisation and tightening of labour markets. This has prompted a gradual build-up in wage-price pressures.

13. I do not want to minimise the inflation risks in Asia – no central banker would take a light attitude towards inflation risks – but I do want to put the issue in perspective.

14. Some of the price pressures facing Asia are no doubt structural. We can expect the relative price of food – and commodities in general – to increase over the medium to long term on the back of growing global demand especially in the emerging economies. Likewise, capital will continue to flow from advanced economies to emerging economies, reflecting growth differentials and a shift in global portfolios towards higher yielding Asian assets. These two factors will be a source of inflation bias in emerging Asia over the medium term.

15. But a good part of the inflation in Asia is also temporary. The pace of food price inflation and capital inflows into Asia will moderate compared to the last two years. Much of the recent food price increases reflect the impact of supply disruptions, and these are largely expected to be of a temporary nature. Capital inflows are also unlikely to persist at the volumes seen in the last two years, as monetary policy settings in the advanced economies are normalised.

16. More importantly, policymakers in most Asian economies are not behind the curve, or at least not anymore. Central banks in ASEAN are deeply cognisant of underlying inflation risks. They have either hiked interest rates or allowed the exchange rates to appreciate over time or done both. Malaysia and Thailand have raised policy rates by four and six times respectively since early 2010. Key ASEAN countries are also relying more on exchange rate appreciation to dampen import price pressures.

17. In Singapore, MAS preemptively tightened exchange rate policy as early as April 2010. Subsequently, exchange rate policy was tightened in October 2010 and again in April this year. Allowing the Singapore dollar to strengthen has had a dampening effect on inflation in Singapore, which would otherwise have been much higher. Headline inflation has probably peaked in Singapore and is expected to average 3 to 4 per cent this year. Core inflation – which excludes private transport and accommodation costs – is expected to be 2 to 3 per cent this year.

18. ASEAN policymakers have also been complementing monetary policy actions with macroprudential measures aimed at managing the inflationary effects of strong inflows of short-term capital. Indonesia has increased the holding period for its short-term debt, while Thailand has imposed a withholding tax on interest and capital gains earned by foreign investors on Thai bonds. Singapore has also implemented a series of macroprudential measures to curb speculative activity and to ensure a stable and sustainable property market.

19. Most ASEAN-5 economies, including Singapore, have also scaled back the expansionary fiscal policies introduced during the crisis.

20. In short, ASEAN policymakers have been proactive in addressing inflationary pressures but will need to remain vigilant because the risks are not over yet. Inflation is expected to peak this year and moderate going into 2012. The ASEAN economies' hard-won macroeconomic stability will give them the resilience to ride a challenging external environment.

Integration: towards a single market

21. Even as they build up their resilience, the ASEAN countries have been working steadily towards greater economic integration. ASEAN has committed to building by 2015 the ASEAN Economic Community ("AEC"), a single market and production base. This will allow goods, services, investments and capital to flow more seamlessly across the ASEAN region. More importantly, it will give ASEAN an economic heft and relevance that corresponds to that of China and India.

22. The different levels of development within ASEAN has been often cited as a reason why integration will not work in ASEAN. On the contrary, the different sources of comparative advantage and therefore factor prices across ASEAN, offers a powerful incentive to develop an efficient pan-ASEAN production network. Indeed, this has already happened in manufacturing, especially electronics. It needs to happen across a broader set of economic activities. The economic case for ASEAN integration is strong. It is a matter of political will to make it happen.

23. Progress in integration has been strongest in merchandise trade. The ASEAN-6 countries have eliminated tariffs on 99.7 percent of goods. Cambodia, Laos, Myanmar and Vietnam have committed to reduce tariffs on 98.6 percent of goods to zero to five percent.

24. But as all cross-border businesses know very well, enhancing trade links is not just about reducing tariffs. It is equally, if not more, about reducing non-tariff barriers and streamlining regulations. In May last year, the ASEAN Trade in Goods Agreement ("ATIGA") came in to effect. The ATIGA not only entrenches tariff reductions, it also lowers the cost of doing business and simplifies trade-related transactions through enhanced trade facilitation measures and customs procedures.

25. Liberalisation of cross-border services in ASEAN has also intensified, albeit slower compared to goods. ASEAN has committed to remove substantially most restrictions on trade in services through eleven packages of commitments under the ASEAN Framework Agreement on Services ("AFAS"). In financial services, members are working to progressively liberalise the insurance, banking and capital markets sectors. The aim is to

provide financial institutions operating in ASEAN better access to the entire ASEAN customer base, and facilitate regional expansion.

26. In addition to facilitating internal integration, ASEAN has been active in linking up with other Asian economies through its strategy of open regionalism. ASEAN has a number of Free Trade Agreements with key Asian economies, including China, Japan, India and Korea. These pan-Asian linkages enable ASEAN to serve as a springboard for investors seeking access to key markets in Asia.

27. Indeed, measured by the degree of intra-regional trade, Asia is already the second most integrated region in the world, after the European Union. And ASEAN is at the nucleus of this expanding network of trade and transport connections spanning Asia.

Opportunity: investment in infrastructure

28. A resilient and integrated ASEAN offers considerable investment opportunities, especially in infrastructure.

29. The demand for infrastructure investment in the region is significant. A report released by the Asian Development Bank Institute ("ADBI") estimates that the total investment needs for national infrastructure development in Asia, from 2010 to 2020, will total about US$8.2 trillion, or an average of US$745 billion per year.

30. But supply – in terms of actual public and private infrastructure investment – has not matched demand. The World Bank has estimated that private sector investment into Asian infrastructure from 1990 to 2008 totaled just US$423 billion or an average of US$22 billion per year. The four ASEAN nations (Malaysia, Vietnam, Indonesia and Thailand) included in the ADBI study, allocated in the fiscal stimulus packages introduced during the crisis a total US$37 billion to infrastructure spending. Comparatively, the four nations' estimated investment needs from 2010 to 2020 total US$874 billion, or an average of US$80 billion per year.

31. This gap between demand and supply needs to be met. Better infrastructure will enhance connectivity, reduce the cost of transactions, and help to grow markets.

32. While Asia's infrastructure needs have traditionally been financed largely by government debt, Asian governments are increasingly recognising that their own balance sheets cannot support the required scale of infrastructure development. Thus, private sector participation is welcome in the region.

33. But public-private partnerships ("PPP") in Asia face not insignificant risks. PPP policies are not always well-defined, regulatory and legal systems are sometimes weak, and there are varying restrictions on foreign ownership.

34. Robust legal frameworks and clear PPP policies need to be put in place. Singapore has been supporting such efforts in partnership with multilateral agencies such as the World Bank.

35. In 2009, we established the World Bank-Singapore Urban Hub to bring together Singapore's public agencies, research institutes, and private sector players to share experiences with developing countries, especially in areas such as water and waste management, land use planning, and urban development. To expand the Urban Hub's infrastructure finance advisory work, an Infrastructure Finance Centre of Excellence (IFCOE) was launched last year.

36. The Urban Hub has also partnered the Singapore Cooperation Enterprise – a platform that leverages on the public sector expertise of Singapore. Together, they have implemented six projects in Indonesia, Vietnam, China and Mongolia. This includes helping these governments develop a regulatory and financing framework to prepare PPP projects for private sector investment.

37. Regional governments have also introduced schemes to encourage private sector investment. For example, the Indonesian Ministry of Finance has worked with the World Bank to set up the Indonesia Infrastructure Guarantee Fund. This fund provides guarantees to the private sector against risks arising from government actions, so as to improve the creditworthiness and quality of PPP infrastructure projects.

38. A critical success factor for achieving Asia's infrastructure investment potential is a well-developed financial sector. Asia needs financial markets that are deep enough to effectively intermediate its considerable savings pool and broad enough to provide a range of suitable instruments for risk mitigation. Although ASEAN has made progress on these fronts since the 1997 crisis, more needs to be done. These include strengthening legal and regulatory frameworks, increasing market access, harmonising cross border regulations, and raising the level of corporate governance.

39. ASEAN has set in motion several initiatives. It has drawn up a scorecard to identify gaps in the development of bond markets. Its capital markets regulators are working on initiatives to harmonise domestic laws, regulations, and practices. It has introduced the ASEAN Plus Standards, which are disclosure requirements based on the standards on cross-border offerings set by the International Organisation of Securities Commissions ("IOSCO"). And last month, some ASEAN exchanges announced plans to establish linkages to facilitate trading among them as well as to jointly market themselves to international investors.

40. It is early days yet. ASEAN is still some way to having a well-developed and integrated capital market. But the resolve is strong, important steps have been taken, and progress has been made compared to ten years ago. And as ASEAN's capital markets grow and integrate, long-term investments such as infrastructure will become much more attractive to private sector players.

Conclusion

41. Let me conclude. ASEAN is a diverse collective of nations at various stages of development. In some ways, this is a disadvantage compared to sovereign economies like China and India. But in other ways, it is an advantage, providing investors in Asia a good diversification opportunity and the value proposition of a network of value-adding activities leveraging on the different comparative advantages of its member countries.

42. I congratulate Bank of America-Merrill Lynch for organising this impressive conference. You have put together a comprehensive line-up of topics that go into the specifics of investment opportunities in Asia. I wish you fruitful discussions and an enjoyable time in Singapore.

Thank you.