



**S. RAJARATNAM SCHOOL
OF INTERNATIONAL STUDIES**
A Graduate School of Nanyang Technological University

RSIS COMMENTARIES

RSIS Commentaries are intended to provide timely and, where appropriate, policy relevant background and analysis of contemporary developments. The views of the authors are their own and do not represent the official position of the S.Rajaratnam School of International Studies, NTU. These commentaries may be reproduced electronically or in print with prior permission from RSIS. Due recognition must be given to the author or authors and RSIS. Please email: RSISPublication@ntu.edu.sg or call (+65) 6790 6982 to speak to the Editor RSIS Commentaries, Yang Razali Kassim.

No. 080/2013 dated 30 April 2013

Achieving the ASEAN Economic Community: Are the Philippines and Indonesia Ready for 2015?

By Julius Cesar I. Trajano

Synopsis

The Philippines and Indonesia, ASEAN's fastest growing economies, face tough challenges to effectively meet the region's economic community targets. Both countries appear far from being prepared to dismantle barriers to investments and significantly narrow income gap by 2015.

Commentary

Southeast Asia has been gearing up to pursue regional market integration through the ASEAN Economic Community (AEC) initiatives, which are set to be completed by the end of 2015. Although 77.5% of the AEC Blueprint has already been mapped out, realising the remaining politically sensitive goals is immensely laborious.

The Philippines and Indonesia, now considered ASEAN's fastest-growing economies and brightest spots amidst gloomy global economic outlook, are both crucial to the establishment of the AEC. Assessing the level of preparedness of Indonesia and the Philippines to achieve AEC targets, however, indicates some daunting challenges, particularly in three critical areas, namely, (1) free flow of investments, (2) interconnectivity and infrastructure, and (3) poverty reduction and equitable economic development.

Impediments to investments

Both the Philippines and Indonesia still perform poorly in eliminating stumbling blocks to investments as they ranked 138th and 128th, respectively out of 185 countries in the World Bank's 2013 Ease of Doing Business Index. Both remain reluctant to open up their protected services sector to foreign investors.

In 2012, FDI inflow in the Philippines rose by 10% to US\$2.033 billion. However, this figure is dwarfed by Indonesia's \$22.8 billion, Malaysia's \$10 billion and Thailand's \$8.1 billion. Clearly, FDI remains the missing piece in the Philippines' growth story.

The stifling foreign investment cap in the Philippine Constitution has been a long-standing issue for foreign investors, apart from rampant corruption. The 40% limit of foreign ownership of companies could be aimed at shielding domestic businesses from competition. President Benigno Aquino's refusal to endorse a constitutional amendment gives a wrong signal to foreign investors that the country is not yet open for business.

Indonesia, ASEAN's largest economy, is among the region's top destinations of FDIs primarily due to its huge domestic market. However, FDI inflows could have been higher, given the country's competitive advantages. Foreign investors face some risks emanating from the failure of the Indonesian government to address regulatory issues and policy missteps.

The resurgence of economic nationalism and protectionism as well as the imposition of new restrictive business measures have coincided with policymakers' growing concerns over the weakening rupiah and widening trade deficit. One such measure was the imposition of an export tax of 20% for 65 mining commodities last year ahead of a full export ban on unprocessed mineral ores in 2014. There is now a rule restricting foreign ownership of mining assets at 49%. Restrictions have been set on the exportation of unprocessed raw commodities and importation of finished goods and certain agricultural products in a bid to protect local producers and farmers.

The vestiges of protectionism and economic nationalism in both countries continue to hinder investment flows in the region. While it protects the interests of sensitive domestic sectors, including politically entrenched tycoons, protectionism has to be abandoned in order for both countries to flourish in the immensely competitive AEC.

Delayed infrastructure and connectivity projects

In order to facilitate the free flow of goods and investments, ASEAN needs to lower transportation and logistics costs between and within member countries. The World Bank's 2012 Logistics Performance Index reveals that the Philippines and Indonesia are ranked 52nd and 59th, respectively out of 155 countries, lagging behind Singapore (1st), Malaysia (29th) and Thailand (38th). The delays in the construction of badly needed infrastructure projects in the Philippines and Indonesia are primarily due to bureaucratic bottleneck, red tape and misplaced costly priorities such as subsidies.

The Aquino administration must catch-up in terms of transport and power infrastructure development, which investors have long complained about. Manila has allotted a record \$9.6 billion budget for public infrastructure. But it merely spends about 2.5 to 3% of GDP on infrastructure, below the 5% average for ASEAN. Most of the public – private partnerships (PPP) projects have yet to take off the ground.

President Susilo Bambang Yudhoyono vowed to boost Indonesia's infrastructure spending by 15% this year or \$20 billion. But the government released only \$1.06 billion in the first quarter of this year while \$2.47 billion from last year's infrastructure budget remains unspent. In addition, 10 major infrastructure projects worth \$9 billion - all private public partnerships – remain at a standstill. Infrastructure spending account for merely 3 to 4% of GDP, compared with pre-Asian crisis levels of 7%.

Reality check: mind the gap

The development divide among ASEAN members has frequently been cited as a challenge to the region's economic integration. However, even in each member-state, there have been domestic concerns over widening income gap. The Philippine and Indonesian economies are rapidly growing, but the trickle-down effect has not yet been felt by poor households.

The Philippines' current poverty rate of 27.9% has virtually remained unchanged since 2006. Income inequality persists as the total income of top 20% families is eight times the total income of bottom 20% families. Growth remains exclusionary and rural poverty is pervasive.

Meanwhile, 11.7% of Indonesians lived below the poverty threshold as of September 2012, which was just a 0.3% reduction from March 2012. Nearly 94 million Indonesians are highly vulnerable to political and socioeconomic shocks which can send them into poverty. Development gap among provinces is still wide-ranging: poverty incidence in some eastern provinces is even higher - 24.1% in Maluku and Papua while it is only 3.7% in Jakarta.

Both countries have their respective populist conditional cash transfer programmes but their long-term efficacy to extricate millions of their citizens from the poverty trap remains uncertain.

ASEAN's efforts to create a single market by 2015 are certainly in their toughest phase. The challenges being faced by Indonesia and the Philippines alone already illuminate some of the roadblocks ahead for the AEC. Both countries need to dismantle non-tariff barriers to cross-border trade and investment and close socially divisive development gap; short-term populist and protectionist policies are certainly not among the solutions.

ASEAN leaders already admitted that more work is required on domestic reforms, infrastructure, trade and

investment impediments and other regulatory hindrances. Otherwise, the 'one community' dream may crash into reality.

Julius Cesar I. Trajano is a Senior Analyst at S. Rajaratnam School of International Studies (RSIS), Nanyang Technological University.