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Southeast Asia at the crossroads: Three paths to prosperity

McKinsey Global Institute

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Southeast Asia is well placed to prosper in the twenty-first century. The region is strategically located between major markets like China, Japan and India, and has a young, growing population larger than either the European Union or North America. Indeed, if ASEAN were a single country it would already be the 7th largest economy in the world with a combined GDP of $2.4 trillion in 2013. The region already attracts significant FDI, not least from Japan, and is a central hub for many global production networks. But further regional integration will be necessary if the region is to reach its full potential—not least through the realization of the vision for the ASEAN Economic Community.

This report from the McKinsey Global Institute (MGI) entitled "Southeast Asia at the crossroads: Three paths to prosperity" identifies three major global trends that have the potential to boost Southeast Asia's development: global flows of goods and services, urbanization and disruptive technologies Each of these trends, if harnessed with the right policies, can bring estimated benefits to the region worth hundreds of billions of dollars by 2030. Some sectors will benefit more from growing global flows (such as manufacturing, retail and business services) while others will benefit more from urbanization (agriculture and real estate). The deployment of disruptive technologies will touch on almost all areas of the economy.

Compared to the European Union and the NAFTA, ASEAN is still in the early stages of economic integration. Governments thus need to tackle the remaining barriers to trade and investment in order to benefit from growing global flows of goods, services and capital. While tariff barriers to trade are falling quickly other types of barriers are not. Indeed, the result of a MGI survey of over 96 businesses identified as top priorities the liberalization of FDI; the harmonization of standards; and the improvement in the efficiency of procedures. Services sector integration also lags behind integration of goods markets. Some sectors such as logistics and financial services have particularly high potential impacts on growth if more fully integrated. The report highlights that enhancing labour productivity will be crucial if the region is to remain attractive for FDI. In particular, countries with higher labour costs, like Malaysia and Thailand, need to shift towards more sophisticated and higher value added production. ASEAN is also lacking pan-regional champions among the business community who can advocate with governments for further integration. Local companies tend to limited to one country; those operating across ASEAN are generally external multinationals.

Urbanization is the second megatrend which can benefit Southeast Asia. The population share living in cities, at only 36 per cent, is low when compared to Western Europe, North America or even South America. Much of the projected urbanization will take place across 215 middleweight cities which are already currently growing faster than their capitals. These cities will account for almost 40 per cent of the region's GDP by 2030.

Urbanization generally delivers benefits related to productivity and higher incomes. When migrants move to cities they augment their productivity and earn higher wages. Migrants also send remittances to rural areas and this further boosts development. Higher incomes associated with urbanization are projected to produce a consumer class of 163 million households by 2030 compared with 81 million today.

However, unless urbanization takes place within a coherent plan based on a long-term sustainable vision, the benefits of urbanization can be choked off by congestion and pollution. Separate MGI research shows that ASEAN's infrastructure level lags behind the world average. They estimate that a further $3.6 trillion will be required for real estate construction by 2030, and another $3.4 trillion in non-real estate investment. Investment on this scale will be beyond the capabilities of many ASEAN countries and is between two and six times the historical level of infrastructure spending. In this context, private investment in the form of Public Private Partnerships will have a big role. Improved project management and project selection are also key, as the experts interviewed for this report make clear. Countries need to have infrastructure plans that follow their broader national strategy. As they are starting from a low baseline, ASEAN countries also have the possibility to "get it right the first time" by integrating infrastructure and land usage into their planning processes.

Disruptive technologies can also be the catalyst of future growth, not only in ASEAN or developing countries but also in developed countries. Today ASEAN has a relatively low level of innovation and digitalization, with the exceptions of Singapore, Malaysia and Brunei Darussalam. Yet this means that there is the possibility of a digitally-driven growth and technology leapfrogging in many areas. The report identifies five different disruptive technologies that have the potential to boost development in ASEAN: the mobile internet, big data, the internet of things, the automation of knowledge and cloud technology. Specific traits of the region's economy and geography influence how these technologies will usefully be deployed. For instance, the archipelagic nature of the region creates substantial barriers to transport and connectivity. So, technologies that are able to reduce distances and to improve the logistic networks are going to be particularly valuable as they connect citizens in remote areas, as well as connecting businesses to the world. In addition, higher use of automation technologies can improve the overall productivity compensating for a lack of skilled labour.

Many users from the region are now accessing the internet only from their mobile telephones and tablets, skipping the use of desktop PCs. This trend towards the mobile internet will increase as the availability of wi-fi or high-quality data networks spreads. New services such as mobile banking and mobile payments or telemedicine will emerge providing previously underserved customers with better access. Other disruptive technologies include the emergence of 'big data' and the 'internet of things' which refers to the network of sensors and actuators embedded in machines and other objects. This network connects these objects with one another and can have usages in supply chain management and infrastructure, highly important for a trading region like ASEAN. Separately, the growing automation of relatively knowledge-intensive work may compensate for the low endowment of skilled labour in some ASEAN countries but it could also depress wages in some sectors. Cloud technology refers to the possibility of having access to a shared pool of computing resources such as servers, storage and applications. Many SMEs have limited access to IT services today but the cloud technology has the potential to change this quickly without tying up substantial capital.

Together, these technologies will impact various sectors, both public and private, but the financial sector and infrastructure may be most affected. Regulators will need to review traditional frameworks which might no longer be suited for these technologies. For instance, new actors may emerge outside the scope of existing regulations. For instance, mobile banking services could be introduced by telecom companies.

This MGI report usefully highlights the enormous variety of trends that will impact ASEAN over the coming years. The region can benefit from the significant new opportunities emerging, but it will need to also navigate the pitfalls. In doing so successfully, effective government strategies will be crucial if obstacles like corruption, financial exclusion, and inefficient infrastructure management are not to derail progress. External variables outside the control of the region, though not covered in the report, will also be crucial. The region therefore needs to be not only smart but flexible, as while some future trends are clearer than others there will always be surprises in store.

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