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ASEAN ECONOMIC COMMUNITY 2015: WHAT DOES IT MEAN FOR CAMBODIA'S ECONOMY AND FOR BUSINESS?

AEC and five principles of economic liberalisation

The goal of the ASEAN Economic Community (AEC), one of the three pillars of ASEAN integration, is to establish ASEAN as a single market and production base for a more integrated, dynamic and competitive region by the end of 2015. The AEC involves five fundamental liberalisations to ease the movement of goods, services, capital and skilled labour within the ASEAN region.

Panel discussion on ASEAN Economic Community 2015 - Coming Ready or Not! Cambodia Outlook Conference, Phnom Penh, March 2015

- **Free flow of goods** involves the elimination of tariff and non-tariff barriers to intra-regional trade. It also covers measures related to trade facilitation such as harmonisation of tariff lines, and simplifying and standardising customs procedures through an ASEAN Single Window. This component fosters market integration and increased intra-ASEAN trade. Average intra-ASEAN tariffs went from 13 percent in 1993 to near zero in 2013 (KPMG 2014) and were correlated with a sharp increase in intra-ASEAN trade, tripling between 2000 and 2013 to USD607 billion (EIU 2014).
- **Free flow of services** entails the removal of restrictions on barriers to trade in services such as foreign ownership, market access and service provider mobility. ASEAN member states have eased cross-border trade in at least 80 subsectors, with most of these subsectors allowing for majority foreign ownership. The service sector is a significant part of any country's economy in terms of both output and employment, and will grow if barriers are lowered.
- **Free flow of investment** provides enhanced protection to all ASEAN investors and their

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In this Issue

investments in other ASEAN countries; more transparent, consistent and predictable investment rules, regulations, policies and procedures; and progressive liberalisation of investment regimes. A 2013 survey of ASEAN competitiveness revealed that investor interest in the ASEAN region was strong and more businesses were seeing ASEAN as an integrated region when making their investment decisions. Foreign direct investment (FDI) in ASEAN has increased steadily, with average growth of 14 percent since 2000. In 2000, annual intra-ASEAN FDI stood at just USD0.9 billion. By 2013, the figure had grown to USD21.3 billion (EIU 2014).

- **Free flow of capital** strengthens ASEAN capital market development and integration through greater harmonisation of capital market standards; eases mutual recognition arrangements and agreements for the cross-border acceptance of qualifications, education and experience of market professionals; and enhances the withholding tax structure (ASEAN 2008). It also allows greater capital mobility by removing or relaxing restrictions on capital flows and current account transactions. As capital markets become more joined up, companies will be able to access deeper pools of liquidity for raising money (KPMG 2014).
- **Free flow of skilled labour** supports greater mobility of qualified professionals within ASEAN. "Free flow" means a flow managed through regional rules and subject to national laws and regulations. Actions to implement this provision include facilitating the issuance of visas and employment passes for ASEAN professionals, deepening cooperation between universities in Asia through the ASEAN University Network (AUN), and developing core competencies and qualifications for occupational skills training. Mutual recognition arrangements (MRAs) provide the main mechanisms for regulating skilled labour mobility. ASEAN has so far concluded MRAs in eight professions, encompassing engineering, nursing, architecture, surveying, medicine, dentistry, accountancy and tourism. Some of the details of these MRAs are still being negotiated and will be implemented post-2015.
- **Free trade arrangements** (FTAs), along with the AEC, provide a growing bilateral and multilateral trading network with the world's largest economies, including China, Japan, South Korea, India, Australia and New Zealand, making ASEAN a hub for Asia's FTAs. As well as maintaining centrality, the configuration of FTAs establishes a policy and legal framework for trade and investment with and in ASEAN (KPMG 2014).

AEC has made slow progress but is now moving forward

The AEC Scorecard, which measures compliance with AEC deliverables by each member economy, indicates that ASEAN has made good but uneven progress in implementing the AEC. By the end of 2013 it had completed 221 (79.7 percent) of the 277 measures. The biggest strides have been made in Pillar 3, which involves creating a region of equitable economic development. Progress in other areas of the AEC has been more modest, with implementation rates of 81 percent for establishing ASEAN as a single market and production base (Pillar 1), and 77 percent each for achieving a highly competitive economic region (Pillar 2) and fully integrating ASEAN into the global economy (Pillar 4).

Despite the Scorecard results, opinions about ASEAN's progress towards realising the AEC are divided. Some critics say progress has been too slow, with little headway made on some major issues. Problem areas include the improper use of non-tariff barriers, for example burdensome customs procedures (Austria 2013); limits on foreign equity ownership and restrictions on land ownership; restrictions on skilled labour mobility across national boundaries (Das et al. 2013); and lack of harmonisation and standardisation of customs procedures. Restrictions on foreign investment and ownership remain the biggest barriers to trade (Woetzel et al. 2014).

A more optimistic view regards the AEC as a major stepping stone to deeper region-wide integration and fuller integration into the global economy. Although awareness of the AEC and its implications for businesses remains patchy, the majority of surveyed investors and business leaders are more positive about its achievements and direction, with more companies buying into the ASEAN vision (KPMG 2014; ECN 2013). Businesses surveyed reported that ASEAN integration policies are starting to be more meaningful for them. “The pace of change is slow, sometimes frustratingly slow, but what’s important is the direction of change” (Pushpanathan Sundram, managing director of EAS Strategic Advice, quoted in ECN 2013, 11).

The Scorecard results show that due to the openness of its economy, as well as government and business commitment to specific AEC-related reforms, Cambodia has done well in meeting key milestones and now ranks in third place, behind Singapore and Malaysia. Cambodia’s overall performance has been above average in meeting various indicators leading to full implementation of the AEC, The only exception is the fulfilment of obligations pertaining to taxation and customs procedures, an area that requires serious government commitment to reform.

AEC offers business opportunities

Most companies surveyed in ECN (2013) and Wong and Wirjo (2013) perceive the AEC as more of an opportunity than a threat given the potential gains that can be had from more open, integrated and connected ASEAN economies and better links to global markets and production networks. ASEAN has become more attractive to investors due to the many success stories generating greater interest from both within and outside the region. First, is its rapid and sustained economic growth. Between 1999 and 2012, the ASEAN region grew in real terms by an annual average rate of 5.5 percent, doubling to a combined GDP of nearly USD3 trillion (KPMG 2014). Along with rapid expansion of the regional economy are its huge population, 617 million, and the rise of a vibrant middle class. It is forecast that the number of middle-class households in ASEAN will rise from 40 million in 2010 to 85 million in 2017, increasing consumer-spending power (ECN 2013). Second, ASEAN has successfully transformed itself into one of the world’s most vibrant manufacturing hubs. In light of rising labour costs in China, the region now represents an even greater opportunity as a manufacturing hub due to its high availability of low-cost labour. Further, the AEC can reduce production costs and improve efficiencies through economies of scale and specialisation (ECN 2013). Companies from the United States, European Union, China, South Korea, Japan and Australia are looking for cost and production efficiencies, making ASEAN an attractive investment destination.

AEC membership holds many benefits for Cambodia. Coupled with broader Asian regional cooperation and integration, particularly with China, Japan and South Korea, the AEC will promote physical connectivity, expand access to regional markets, resources and investments, increase participation in regional production networks and drive domestic reforms. Thus it will improve the overall business and investment climate. All of these will all contribute to accelerating productivity, employment generation and economic growth (Hing and Strange 2014). The AEC is expected to increase Cambodia’s real GDP by 4.4 percentage points, exports by 5.3 percentage points and private investment by 24.8 percentage points (Itakura 2013). However, education levels and human capital development in Cambodia continue to lag behind that in most other countries in the region. Consequently the country’s labour market is plagued by serious skills mismatches and skills gaps. In the short term, Cambodia can benefit from the freer movement of skilled labour through the AEC to tide it over specific occupation skills shortages. In the longer term, Cambodia will need to build a better educated and skilled workforce if it wants to compete successfully in the AEC and beyond (Madhur 2014).

In preparation for the AEC and wider regional integration, Cambodia has recently undertaken several important reforms to improve the economic and commercial climate. For example, it now offers generous investment incentives, especially in areas of 100 percent equity ownership, with generally non-restrictive repatriation of profits, low corporate tax rates and favourable tax exemptions. Even so, more needs to be done to stabilise the business climate and make it more attractive to investors. The current investment environment in Cambodia, along with the added benefits of the AEC, provides positive conditions to sustain investment and growth. In the past year alone, Cambodia has experienced a notable increase in FDI, with large US retail companies like Domino’s Pizza, Kohler Faucets, and Home Top (the official franchise in Cambodia of Do It Best) entering the local market (Todd 2015).

The prospect of broader integrated regional production networks and markets also offers Cambodia a rich seam of investment and trade to spur private sector development and prosperity (Hing 2013). Cambodia has not yet participated significantly in intra-regional dynamics of production sharing, but major structural shifts in global supply chains in Asia promise a new era of opportunity for the emerging economies of Southeast Asia such as Cambodia. Because of rising costs, many firms are moving away from China and relocating production in low-cost countries. This trend is evident in the investment of two Japanese firms—Minebea, a global leader in micro-motors, and Sumitomo Electric, a leading producer of wire harnesses—setting up state-of-the-art production facilities in Cambodia to serve global markets.

Reform, rebranding and positioning of Cambodia to maximise benefits from the AEC and broader regional integration

Cambodia has yet to reap the benefits from the AEC, reflected in the country's low volume of intra-ASEAN trade and limited participation in dynamic regional production sharing. If Cambodia is to maximise the benefits from the AEC and broader regional integration, and add value for business, it needs to undertake further reforms.

- *Improve investment climate:* Despite significant improvements in macroeconomic management, trade facilitation and access to finance and information technology, the Cambodian investment climate remains less conducive than in most other countries in ASEAN, ranking low in business and economic assessments. To be the location of choice for multinationals will involve, among other things, improving the ease of doing business and creating the right incentives. Priorities to remedy investment climate weaknesses include improving infrastructure, streamlining customs procedures, enhancing logistics efficiency and investing in human capital. Also conducive to investment would be deepening special economic zones through superior infrastructure, overcoming bureaucratic and administrative hurdles, creating more flexible employment relationships and ensuring ready access to both low- and high-skilled labour.
- *Upgrade logistics and simplify customs procedures:* among ASEAN member states, Cambodia has some of the least efficient logistics services, stemming from insufficient and poor quality infrastructure, and low efficiency and effectiveness of clearance by customs and border control agencies. Policy interventions can range from improved trade-related infrastructure to better border management, through reforming and modernising customs and wider information sharing, greater competition in trucking, port and airfreight services, and ready access to information about international transit agreements.
- *Invest in human capital:* the educational attainment of the labour force and the formation of human capital lag behind that of most countries in the region, constraining Cambodia's sustained socio-economic development. The country must invest heavily in skills upgrading and human capital development. Improving the education system should be the prime policy focus, with primary and secondary education providing the necessary foundational skills to young people, and higher education and professional and technical education (PTE) building on these skills. To be competitive and to provide quality employment opportunities, Cambodia needs a highly skilled younger generation (especially in science, technology, engineering and mathematics—STEM subjects).
- *Enhance business consultation and engagement:* Despite the existence of effective, national-level mechanisms for consultation between government and the private sector, private sector engagement in ASEAN processes is at best uneven, and there is a lack of awareness about the benefits and opportunities of region-wide FTAs and of regional integration (Chan and Strange 2012). Also, the complex set of rules and procedures creates a burden and leads to confusion for businesses. ASEAN and the government of Cambodia should strengthen information dissemination and consultation with businesses on AEC initiatives. The ASEAN Business Advisory Council emphasises that greater effort must be made to reach out to local small and medium enterprises—to ally their fear of the AEC as a threat to their businesses and alert them to the opportunities it presents.
- *Develop and implement a national industrial development policy:* Cambodia's economy

remains narrowly based in agriculture, garment manufacturing, tourism and construction, but with promising signs of diversification into light industrial manufacturing and agribusiness. If Cambodia is to meet the opportunities and challenges of AEC 2015, it needs to develop and implement a national industrial development policy that promotes industrial diversification and productivity, improved infrastructure and logistics, a skilled labour force that meets dynamic labour market demands, the strengthening of institutions, and a fertile business environment for both domestic and international investments. The Cambodian government will soon release such a policy. However, its implementation will require strong leadership and commitment from the government and its development partners, the business community and education and vocational training institutions, as well as greatly improved cross-ministry and inter-agency coordination and cooperation.

- *Rebrand Cambodia for the AEC and beyond:* Government and businesses agree that Cambodia needs to rebrand itself, moving on from terms like "post-conflict", "least developed" and "aid dependent" to a more positive narrative that, in both substance and perception, presents a more balanced story of Cambodia's remarkable achievements over the past two decades—peace and stability, one of the most open economies in the world, record levels of sustained inclusive growth (an "Olympian of Growth" according to World Bank 2014) and poverty reduction, wide ranging reforms in key areas that create a healthy business environment, a young population with huge potential as skilled labour for industrial diversification and productivity, and a strong commitment to playing a major role as an outward looking, constructive and dynamic player in an integrated ASEAN, a broader Asian region and beyond.

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