press release

EU-ASEAN trade corridor set to expand

- **We see EU-ASEAN trade growing at 4-5% p.a. in the next five years**
- **EU-ASEAN trade is likely to be driven by strong ASEAN domestic demand for high-tech products**
- **An EU recovery and improving ASEAN production capability should boost ASEAN export growth**

Summary

We see significant upside for EU-ASEAN trade after challenges faced in the recent past. The EU and ASEAN have had a consistently strong trade relationship in the past decade, despite the 2008-09 global financial crisis (GFC) and China's rise as a global trade leader. The EU-ASEAN trade corridor is a key trade link between Asia and Europe, closely interconnected with global supply chains. Strong ASEAN domestic demand, along with weak but recovering EU domestic demand, has narrowed the EU's trade deficit with ASEAN in recent years. This reversed slightly in 2014 as domestic demand improved in the EU. As EU domestic demand continues to recover, we see the trade corridor between the two regions regaining momentum lost during the GFC, and growing at 4-5% p.a. in the next five years.

Trade in intermediate goods is strongest between the two regions, although we see rising potential for trade in capital and consumer goods. High-tech products, transport equipment and other manufactured goods will likely continue to dominate trade growth. ASEAN's transport equipment and electronics exports to the EU have the potential to grow more in the next five years, in our view.

ASEAN is slowly increasing its production capabilities. Vietnam, Cambodia and Myanmar will likely register strong export growth in the coming years. Malaysia, the Philippines and Indonesia are also poised to move up the production value chain, potentially expanding the trade corridor. A free trade agreement (FTA) would provide an additional boost, deepening the trade partnership between the two economic blocs.

The EU-ASEAN trade corridor

Solid long-term growth trend

Trade relations between the EU and ASEAN have remained strong throughout the global recession and period of patchy growth following the GFC. Between 2008 and 2014, EU exports to ASEAN grew at a cumulative annual rate of 3.9%, while imports from ASEAN grew by 2.2%. Comparatively, EU total exports to the world rose by 2.7% and imports fell by 0.7% in the same period. Growth in EU-ASEAN trade has been driven by increased trade in manufactured goods for both sides.

China's rise as a trade power and growing trade between emerging markets reduced the EU's share of ASEAN's total exports to 10.2% in 2014 (from 15% in 2000), according to the IMF's Direction of Trade Statistics (DOTS) figures. The EU's share of ASEAN's imports also fell to 9.1% in 2014 from 11.2% in 2000. Still, these declines were less marked than those in the US and Japan. The EU is now a more important trading partner for ASEAN than either of the countries. ASEAN's exports to the US declined to 9.6% of total ASEAN exports in 2014, from 18.9% in 2000. Its imports from Japan also fell to 8.7% of the total in 2014, from 19.3% in 2000.

ASEAN posted a trade surplus of USD 13.8bn with the EU in 2014, according to IMF DOTS. This was smaller than the trade surplus with the US (USD 31.5bn), but bigger than Japan's (USD 6.4bn). The EU trade deficit with ASEAN has narrowed over the past decade due to strong domestic demand in ASEAN. ASEAN imports from the EU grew much faster than its exports to the EU in 2010-14. The trend is most marked for the Philippines and Singapore, whose export growth to the EU has fallen sharply in recent years. ASEAN's merchandise trade balance was supported by Vietnam's exports, as all other economies in the region have registered deteriorating trade balances versus the EU in the past few years.

ASEAN GDP growth has remained resilient since the GFC, supported by robust domestic economies. Many ASEAN economies have shifted from being export-reliant to becoming more domestically oriented. Nominal household consumption grew at an average 10% p.a. between the ASEAN-6 (Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam) in 2010-14, supporting demand for consumer goods. Meanwhile, investment grew 9% p.a. over the same period, boosting capital goods demand.

ASEAN exports to the EU picked up again in 2014

2014 was a weak year for global trade growth, mainly attributable to geopolitical tensions and deteriorating economic fundamentals. EU imports from ASEAN recovered after falling in 2013 and ended 2014 up about 4% y/y, although EU exports to ASEAN were down 2%. EU imports increased on the back of the European economic recovery. Subdued economic growth in ASEAN increased uncertainty and led to lower imports from the EU.

ASEAN exports to China and the US also rose in 2014 versus 2013 – exports to China were up 1%, while exports to the US were up 7%. In contrast, exports to Japan were down 2%. ASEAN imports from the US and Japan were also lower in 2014, by 2% and 6.6%, respectively.

Solid growth for EU-ASEAN trade corridor in next five years

We believe the EU-ASEAN trade corridor will grow faster in the next five years, following subdued growth in the past three years. The Europe recovery is likely to continue near-term – we forecast GDP growth of 1.5% for 2015 and 2.1% for 2016. EU domestic demand is still about 3.5% lower in real terms compared with its peak in 2008. We believe EU domestic demand will increase at a faster pace than GDP growth in the next three years, due to an investment pick-up and growth in consumption. For ASEAN, we expect stable growth between now and 2020.

We expect the EU-ASEAN trade corridor to grow at an average rate of 4-5% p.a. in the next five years. We expect EU exports to ASEAN to grow at a slightly faster pace than imports from ASEAN, resulting in a mild narrowing of the EU's trade deficit, or even a small surplus. This should be supported by the ECB's likely accommodative monetary policy in the next five years, which should keep the trade-weighted euro (EUR) low by historical standards. Easy monetary policy, combined with ongoing structural adjustments, should result in a more competitive European economy, supporting exports. We base this on the expectation that ASEAN domestic demand will continue to grow as the region's middle class expands. The EUR's recent significant depreciation against all ASEAN currencies should support European exports to ASEAN.

Technology products to dominate trade corridor

Composition of the EU-ASEAN trade corridor

EU-ASEAN trade is fairly similar when looking at the broad goods categories. Manufactured goods make up around 60-70% of trade in both directions; chemicals (mostly pharmaceuticals) make up about 14% of EU exports to ASEAN and around 9% of imports. Food-related products make up about 8% in both directions. However, EU imports of raw materials from ASEAN are around 8% of its total imports, whereas EU's raw material exports to ASEAN are negligible.

At a more granular level, the composition of trade varies based on the competitive advantages of each country. In the manufactured goods category, for example, EU exports to ASEAN comprise heavy industry goods, such as cars, airplanes, medical equipment, and oil and gas equipment. EU imports from ASEAN comprise electronic equipment, such as microchips, computers and cell phones. The EU also imports significant quantities of apparel from ASEAN, mainly from Vietnam. Country-level trade patterns between EU countries are fairly uniform, but differ significantly between ASEAN countries. ASEAN trade is highest with the largest European economies (Germany, the UK, France, Italy) and the Netherlands, which is a transport hub.

A high-tech trade corridor

Given the mix of products made in the EU and ASEAN regions, we think the trade corridor will be technology-focused and driven by trade in high-tech goods. We focus our analysis on two categories – electrical and electronics goods, and transport equipment goods.

For electrical and electronics goods, the EU currently imports more than it exports. This is partially due to ASEAN's cost advantage and also to satisfy the EU's demand for intermediate goods and less technology-intensive goods within the category.

Over the next five years, we think EU exports of electrical and electronics goods to ASEAN will rise slightly faster than its imports. ASEAN's robust domestic demand and rising wealth imply higher demand for high-tech products, including items such as medical equipment, specialised factory machinery and other high-quality consumer goods.

The EU's improving growth outlook is also likely to boost demand for ASEAN's electrical and electronics goods. ASEAN's production capability is likely to be enhanced by its cost advantage and worldwide foreign direct investment interest. In the medium term, Myanmar and Cambodia may be able to replicate Vietnam's 110% CAGR rise in electrical and electronics exports to the EU owing to a low-base effect.

The EU exports more transport equipment than it imports (2013: USD 17.4bn exports versus USD 3.6bn) due to its comparative advantage in the production of high-tech land, sea and air transport equipment. For similar reasons, demand from ASEAN has been strong in recent years and the strength is likely to continue. If ASEAN improves its technological capability, we see scope for upside in transport equipment exports to the EU as well.

Services trade is less developed

The EU had a surplus of about USD 5.6bn in services trade with ASEAN in 2013, based on the latest statistics. Most of the services trade was concentrated in the UK-Singapore corridor. According to Eurostat data, the EU has a deficit in transport and travel services, and a surplus in business, financial and computer services.

An FTA would boost trade in both directions

The EU and ASEAN have been in FTA negotiations since 2007. Negotiations have stalled, however, and the EU has begun bilateral FTA negotiations with individual countries.

According to the EU, the goal is still to reach a regional agreement, with bilateral negotiations considered steps towards that goal. Negotiations with Singapore and Malaysia were launched in 2010. No rounds of negotiation are planned currently. An FTA will take time to progress to completion, in our view, but should boost bilateral trade significantly when it is reached. It would likely impact services trade more, as services would grow from a lower base.

The EU launched FTA negotiations with South Korea in 2007 and an FTA between the two economies was established in 2011. The EU-South Korea FTA is the first between the EU and an Asian country. The trade pattern following the FTA shows that EU exports to Korea increased much faster than EU exports to the world. However EU imports from Korea remained stagnant. We believe this pattern reflects weak European domestic demand in the period following the FTA agreement – especially for the type of goods imported from Korea – rather than the FTA terms favouring EU over Korean corporations.

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