

# Macro Note

## ASEAN: Deepening Trade And Financial Inter-Connectivity For Sustainable Growth

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- Enhancing ASEAN connectivity will undoubtedly bring about a more integrated ASEAN that will in turn promote competitiveness, inclusiveness, and a greater sense of community. We consider three main aspects to be further deepened to enhance the inter-connectivity in ASEAN: physical connectivity, trade connectivity, and finally investment and financial connectivity.
- On trade connectivity, ASEAN trade (exports and imports) recorded a sustained growth from USD2.4tn in 2012 to USD3.8tn in 2022 (more than 50% increase in the last decade!). Intra-ASEAN trade, however, remained low as evident from just a 22.1% of share viz. China and US of 18.7% and 10.9%, respectively, which yielded a combined share of close to 30%. In fact, intra-ASEAN trade has not returned to its pre-pandemic share of around 24%.
- As for investment and financial connectivity, in 2021 the amount of FDI coming into ASEAN as a whole has returned to its pre-pandemic level at USD179.2bn, USD5bn above its previous high in 2019. Singapore continues to be the largest recipient of FDI coming into ASEAN in 2021, receiving up to 55.3% of the ASEAN total FDI. This is followed by Indonesia (11.2%), Vietnam (8.7%), and Thailand (8.2%).
- The most recent and notable progress on financial connectivity in ASEAN is the promotion of local currency settlement (LCS) initiatives. LCS has a significant impact on international trade and FDI. In 2022, international trade using LCS in Indonesia was recorded at USD3.8bn, rising 50.2% from 2021 of USD2.5bn. The achievement of transactions through LCS in 2022 is a notable improvement as compared to the pandemic period which only amounted to USD797mn. The LCS agreement in the ASEAN region will continue to be implemented into a wider range of international trade transactions.

### An Overview On ASEAN Inter-Connectivity

ASEAN connectivity master plan envisions a seamless, comprehensive, connected, and integrated ASEAN that will promote competitiveness, inclusiveness, and a greater sense of community. We consider three main aspects to be further deepened to enhance the inter-connectivity in ASEAN: physical connectivity, trade connectivity, and finally investment and financial connectivity.

For physical connectivity, progress on major infrastructure projects supporting physical connectivity in ASEAN has continuously been stepped up. Most ASEAN countries have seen improved road constructions in 2022 and a notable point will be for Indonesia - the largest archipelago country in ASEAN - which recorded a larger improvement in road infrastructure. The Indonesian government has increased its focus to enhance local value chain by strengthening the infrastructure as the first step of Indonesia's inter-connectivity master plan. This embodies a massive road construction not only centralized in Java and west Indonesia, but also

with intention to extend to the eastern region, especially in Sulawesi, Maluku, and Papua (Sulampua). Compared to its ASEAN peers in terms of total paved-roads' length, Indonesia ranked third behind Thailand and Vietnam. Better road infrastructure and thus better connectivity could be the key catalyst for driving higher productivity of industries, reducing intra-regional disparity, and attracting higher investment.

Improvement in productivity of ASEAN will be crucial for two interrelated reasons. The first is to maintain the steady pace of growth momentum in the region. This is especially so given that the younger demographics in ASEAN are relatively more favorable compared to most other countries. As such the longer-term benefits to economic growth from an expanding workforce with better productivity will support higher and more sustainable growth. To this end, several initiatives that ASEAN has committed into in the spirit to enhance physical connectivity is applauded, such as ASEAN Framework Agreement on the Facilitation of Goods in Transit (AFAFGIT), ASEAN Framework Agreement on the Facilitation on Inter-State Transport (AFAFIST) and ASEAN Framework Agreement on Multimodal Transport (AFAMT). Furthermore, ASEAN members also agreed to implement Free Trade Area (AFTA) agreements in all ASEAN regions and annually hold the Regional Comprehensive Economic Partnership (RCEP) meeting to discuss and fix economic issues in the region.

Physical interconnectivity has also been beefed up as evident from the higher number of international ports (both sea and air) to support logistics activity. In 2021, there were 639 international ports in ASEAN, around 25% higher compared to five years ago. This significant increase is underpinned by massive international standard port developments in the Philippines and Indonesia. However, other countries such as Brunei Darussalam, Cambodia, Malaysia, and Thailand are relatively stagnant. Though different demographic characteristics between regions are the main factors that caused disparity in the availability of international ports in ASEAN, having more interconnection especially in seaports for archipelagic countries such as Indonesia and the Philippines, are highly important to support trade activities.

Figure 1. ASEAN's Length Of Road

Source: ASEAN Statistics, UOB Global Economics & Markets Research

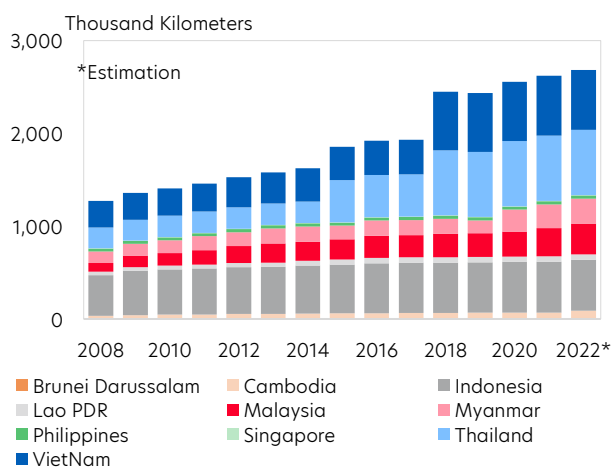
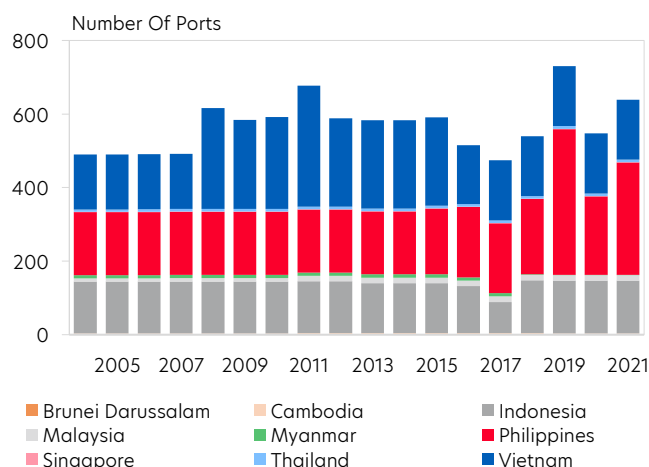


Figure 2. ASEAN International Port

Source: ASEAN Statistics, UOB Global Economics & Markets Research



### Higher Integration Is Needed To Increase Intra-ASEAN Trade

ASEAN trade (exports and imports) recorded a sustained growth from USD2.4tn in 2012 to USD3.8tn in 2022 or around 54% growth over the last decade. Intra-ASEAN trade, however, remained low as evident from just a 22.1% of share viz. China and US of 18.7% and 10.9%, respectively, which yielded a combined share of close to 30%. In fact, intra-ASEAN trade has not returned to its pre-pandemic share of around 24%. During the Covid-19 Pandemic, intra-ASEAN trade declined slightly from 22.5% to 21.2% in 2020. Mobility and economic activity restrictions during the pandemic heavily impacted intra-ASEAN trade, notably evident from more than 10% contraction for exports during the year. However, exports to the US and China still managed to record growth of circa 15% and 8% respectively in 2020. At the current run-rate, intra-ASEAN trade is likely to return to its pre-pandemic level fairly soon.

To have a clearer picture, we look at the trade balance position of selected ASEAN economies. As of end 2022, ASEAN trade position in the last quarter showed a relatively strong surplus of USD27.4bn, up substantially from 3Q22's USD18.2bn. By commodity, ASEAN trade surplus is underpinned by electrical machinery and equipment parts that are mostly exported to China, EU, and Japan. Second largest component driving the surplus comes from animal or vegetables products, which are mostly shipped to China, India, EU, and US. Electronic and Electrical (E&E) is one of the key exports from Singapore, Malaysia, and Vietnam, contributing close to 81% share of the total ASEAN E&E exports in 2022. This is one of the most resilient sectors in ASEAN as even during the pandemic, E&E exports rose 7.7% in 2020, an improvement from previous year of 0.6%.

Figure 3. ASEAN Trade Recorded Steady And Recover Faster

Source: ASEAN Statistics, UOB Global Economics & Markets Research

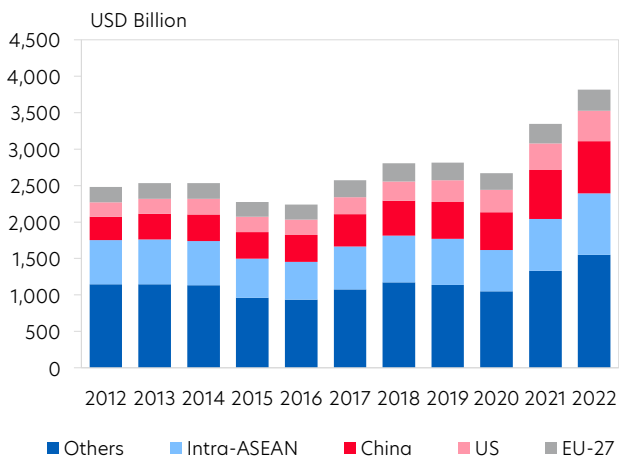


Figure 4. ASEAN Trade Balance Remained Robust In Surplus

Source: ASEAN Statistics, UOB Global Economics & Markets Research

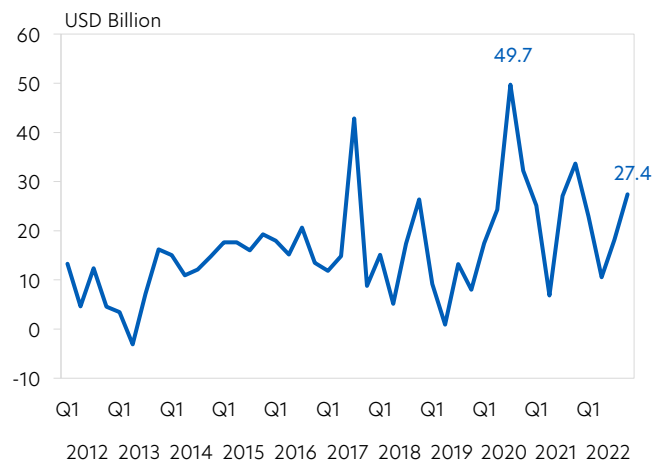


Figure 5. ASEAN-6 Exports By Country

Source: ASEAN Statistics, UOB Global Economics & Markets Research

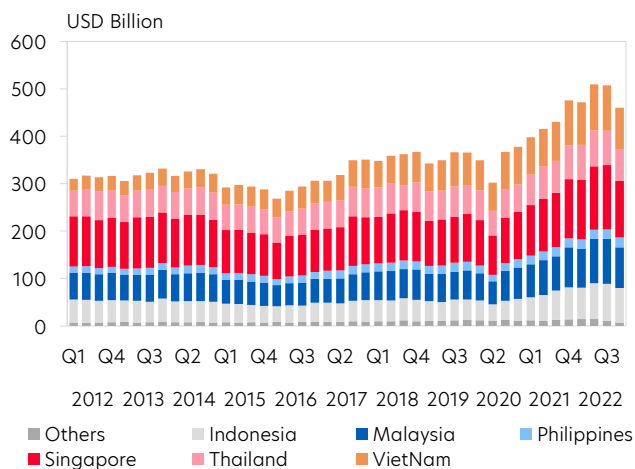
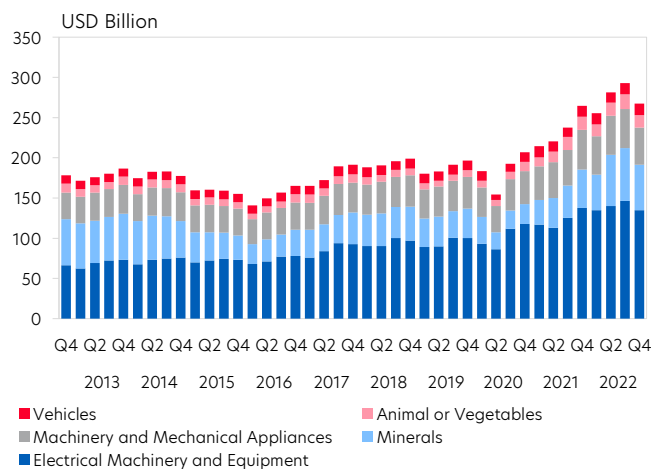


Figure 6. Top 5 ASEAN Exports By Commodity

Source: ASEAN Statistics, UOB Global Economics & Markets Research



Within the region, ASEAN-6 accounts for almost 98% of total value of ASEAN exports with Singapore leading the pack at 26.4%, followed by Vietnam (19%), Malaysia (18.3%), and Indonesia (15%). ASEAN exports grew a strong 13.3% in 2022. This is underpinned by broad-based external demand on mineral and other commodities and E&E that grew 13% and 47.6% respectively. These two sectors combined accounted for more than 40.3% of total ASEAN exports in 2022. On the back of higher down-streaming push in ASEAN, especially in Indonesia, Indonesia's value-added mineral exports jumped by a record 57.5%, driven by key commodities such as coal and oil & gas amid unprecedented return of demand last year. Last year, Indonesia recorded the highest exports growth in recent history, at more than 26%, followed by Malaysia at close to 20%, and Singapore at close to 13%.

### Understanding ASEAN Better As A Net Exporter Or Importer

ASEAN recorded back-to-back trade surplus of USD93bn and USD79bn accordingly in 2021 and 2022, supported largely by growth of key ASEAN exports. E&E segment recorded a strong surplus of USD74bn in 2022, 36% higher from 2021's level of USD54.3bn. By export destination, the largest surplus was derived from the US, which increased significantly from USD147bn in 2021 to USD158.4bn in 2022. The second largest source of surplus came from the EU at USD56.4bn.

Meanwhile, ASEAN is a net importer from China with a trade deficit of USD137.3bn in 2022, marking a significant widening from USD106.6bn deficit in 2021. Apart from China, ASEAN also recorded a net trade deficit with Taiwan, South Korea, and Japan in 2022 at USD70bn, USD61bn, and USD2.3bn respectively.

The trade deficit with China was driven by high imports of electrical machinery and equipment, as well as boilers commodities. Each of these commodities recorded a trade deficit of USD46.7bn and USD47.3bn in 2022 respectively. By the type of commodity, most of the imported commodities from China are in raw form as well as in the final capital goods. Nevertheless, this could also portray deeper interest of Chinese massive investment into various countries in ASEAN such as Indonesia, Singapore, and Malaysia. For example, several large projects in the nickel processing industry in Indonesia are among the mega natural resource projects carried out by China in the ASEAN region.

China managed nickel mines and smelters in the Morowali, Konawe and Weda Bay industrial areas. The number of Chinese investment projects in the ASEAN region likely resulted into larger imports of manufacturing machineries and construction equipment from them. Meanwhile, China's investment projects in the manufacturing sector that are already underway also consistently supported imports of raw materials for production purposes such as iron and steel. As such, having stronger investment interconnectivity especially to beef up the regional value chains in ASEAN are necessary to reduce persistently large imports that likely have caused prolonged deficits in many of ASEAN countries. The demand-supply linkage between subsidiary companies in the ASEAN region and parent companies in China is a specific contributing factor to the high import of semi-finished materials into ASEAN.

Similar to China, ASEAN also experienced trade deficits with Japan and South Korea. The trade deficit with Japan was mainly in iron and steel, machinery and mechanical appliances, and also vehicles, which recorded a trade deficit of USD11.7bn, USD10.2bn, and USD7.1bn, in that order. Overall, against Japan, in 2022, ASEAN experienced a trade balance deficit of USD2.3bn, where the deepest deficit was experienced by Thailand at USD9.8bn, Singapore at USD5.9bn, and Philippines USD2bn. Meanwhile, other countries such as Indonesia recorded a large surplus of USD7.7bn, followed by Malaysia at USD3.4bn, and Vietnam at USD0.9bn. Most of the imported commodities from Japan are raw and consumer goods such as galvanized steel for vehicle body raw materials, as well as motor vehicle components. ASEAN is one of the top importers of motor vehicle commodities, vehicle components and parts, as well as boosting several projects in the transportation and manufacturing sectors. However, this could also reflect Japanese constant interest to remain invested in ASEAN. Japan is one of the three countries in the Asian region with the largest investment in ASEAN. South Korea, meanwhile, exports similar products as Japan to ASEAN, especially galvanized steel commodities, electronics, machinery, and vehicles.

Figure 7. ASEAN Balance Of Trade By Country

Source: ASEAN Statistics UOB Global Economics & Markets Research

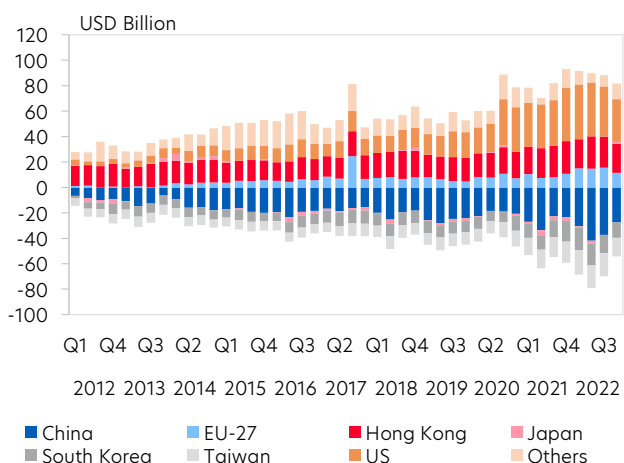
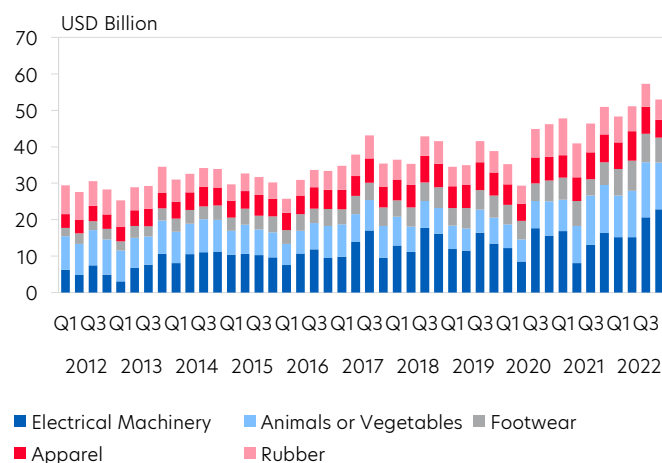


Figure 8. Top 5 ASEAN Balance Of Trade By Commodity

Source: ASEAN Statistics UOB Global Economics & Markets Research



In contrast, ASEAN is a net exporter to the US. In 2022, ASEAN recorded a trade surplus of USD158.4bn, of which more than 46% are electronics-related exports with a surplus amounting to USD73.1bn. Several countries in ASEAN have a long-standing comparative advantage as electronic equipment and machinery exporters such as Vietnam, Singapore, and Thailand with a surplus of USD35.3bn, USD10.4bn, and USD10.7bn respectively in 2022. In addition, textile industry also runs a significant surplus position, taking the form of clothing and accessories, which contributed a surplus of USD27.7bn in 2022, higher than 2021's surplus of USD25.7bn. Overall, Vietnam recorded the highest surplus in 2022 at USD94.9bn, almost five times multiple compared to that in 2021 which only recorded a surplus of USD20.9bn. The second and third positions are Thailand and Indonesia which recorded a surplus of USD29.4bn and USD16.6bn respectively in 2022 (rising 80.6% and 465% respectively from 2021's surplus). Nevertheless, ASEAN continues to be a net importer of air transportation and aircraft spare parts, and also mineral fuels in 2022 of USD7.7bn and USD13.6bn, respectively.

Meanwhile, ASEAN also recorded a large surplus with the European Union (EU) in 2022 of USD56.4bn, much higher than the previous year of USD36.3bn. By country of export origin, Vietnam contributed the most to ASEAN's surplus in 2022 of USD31.3bn or more than 55% of the total surplus in ASEAN against the EU during that period. In the second position is Indonesia with a surplus of USD9.8bn, an increase from the previous year of USD6.9bn. ASEAN's robust surplus was underpinned by surpluses in the electronics and footwear industry which recorded a surplus of USD27.5bn and USD8.4bn respectively, rising from the previous year which was recorded at USD21.2bn and USD6bn, respectively. Electronics industry is a steady industrial base in ASEAN with huge market shares in the US and EU. Meanwhile, ASEAN is a net importer of pharmaceutical commodities from the EU with a deficit balance of USD7.6bn and essential oil commodities with a deficit of USD3.2bn in 2022.

### Substantial Direct Investment Needed To Drive A Robust Growth

In 2021, the amount of FDI coming into ASEAN has returned to the pre-pandemic level at USD179.2bn, USD5bn above its previous high in 2019 and growing close to 50% compared to 2020. Singapore continues to be the largest recipient of FDI coming into ASEAN in 2021, receiving up to 55.3% of the ASEAN total FDI. This is followed by Indonesia (11.2%), Vietnam (8.7%), and Thailand (8.2%). Malaysia recorded the highest growth of FDI in 2021 of 264% y/y, rising from USD3.2bn to USD11.6bn. Meanwhile Myanmar dropped 54.4% from previous USD2.2bn to only USD1bn. Despite the pandemic, Vietnam saw a constant stream of FDI at around USD16bn annually since 2018. Compared to its peers, Thailand was the only ASEAN country to experience an outflow of FDI during the pandemic, to the tune of USD5bn in 2020.

Figure 9. Foreign Direct Investment (FDI) Inward Flows To ASEAN By Host Country

Source: ASEAN Statistics UOB Global Economics & Markets Research

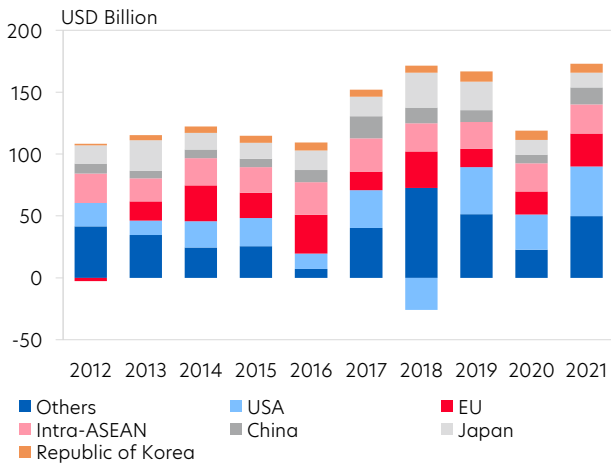
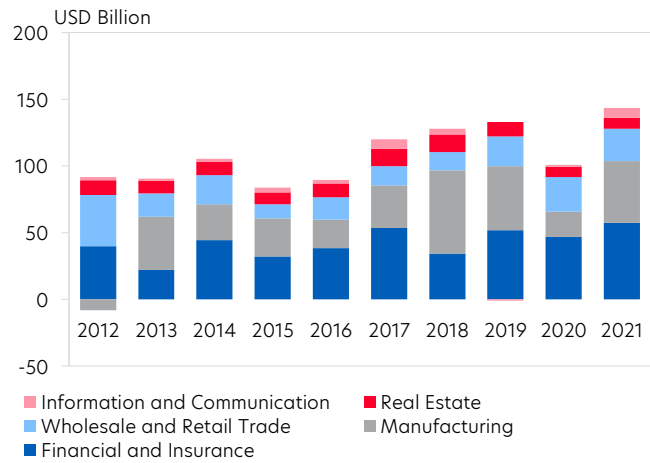


Figure 10. Top 5 ASEAN Balance Of Trade By Commodity

Source: ASEAN Statistics UOB Global Economics & Markets Research



By industry, financial and insurance industry continued to be the largest recipient at 32% share in 2021 (grew 22.8% viz a year earlier). Manufacturing and wholesale & retail trade made up 25.8% and 13.5% of the share respectively. Apart from having a systematically significant share, FDI into manufacturing sector also recorded a robust growth of 143.4% y/y in 2021. An unprecedented supply-side disruption has sparked the post-pandemic industrial expansion in various regions, which led to a surge in investment in the manufacturing sector. In particular, FDI into the information and communication sector grew a whopping 428% from USD1.4bn to USD7.4bn in 2021. The era of “work-from-home” that precipitated huge surge of demand for devices in the communications sector during the pandemic explained such stellar jump. Finally, the real estate industry saw its share of FDI inflow steadily declining from its peak of 8.9% in 2018 to 4.6% in 2021. The agriculture industry had its share dropped from 2.5% to 0.3% in the same period.

In terms of the origins of FDI coming into ASEAN, the US remained as the largest source of FDI in 2021 with 22.5% of the total direct investment into ASEAN. Its FDI funding grew significantly from USD28.7bn in 2020 to USD40.3bn in 2021, with most of it invested in the financial and insurance industry (70.4%) and manufacturing industry (23.5%). Trailing behind is EU at 14.8% of share and Intra-ASEAN at 13.1%. Beside the financial and manufacturing industries, EU invested significantly in the wholesale and retail trade that made up 28.4% of its FDI in 2021 (following a contraction of close to 18% in 2020).

Meanwhile Intra-ASEAN FDI flows steadily grew during the pandemic at 18.5% in 2020 but unfortunately fell to 13.1% in 2021 as other countries returned to investing in ASEAN following the recovery from the pandemic. Singapore accounts for around two-third of the Intra-ASEAN FDI funding, as it contributes 8.8% of the total FDI coming into ASEAN and also the highest contribution to ASEAN intra-investment with 67.4% of share. EU has also increased its FDI funding though the pandemic, maintaining its FDI share at 15.1% in 2020, though it declined to 14.8% in 2021 also due to the return of many other FDI investors into ASEAN. Japan was one of the notable FDI investors into ASEAN but have not made any significant increase in their FDI into ASEAN in 2021, maintaining the amount of FDI they brought in 2021 at the same level as 2020 (a mere 0.7% growth).



## Promoting The Use Of LCS To Further Integrate ASEAN

Recent volatility in the US dollar exchange rate against a number of emerging market currencies has encouraged an alternative use of local currencies in bilateral trade transactions, known as Local Currency Settlement (LCS). The promotion of LCS provides an acceptable alternative of trade settlement in non-USD currencies and is likely to further encourage import and export as well as investment. This will in turn strengthen macroeconomic stability as it provides alternative to circumvent higher US dollar volatility in the trade settlement and provides alternative choices for bilateral trade within ASEAN. Many central banks in ASEAN are continually promoting LCS in the region. LCS is an additional instrument optimized by central banks in ASEAN in order to maintain currency stability in the region as the US dollar continues to strengthen and global economic uncertainty increases.

Indonesia, Malaysia, and Thailand have been promoting their own currencies for use in bilateral transactions through the Local Currency Settlement Framework (LCSF), which the Philippines has recently joined. This is a set of bilateral agreements among central banks to use their own currencies for cross-border settlements of mutual trade and FDI through commercial banks designated as appointed cross-currency dealers (ACCDs). ACCDs conduct direct exchanges of currencies without the triangular transactions of going through the US dollar as a vehicle currency. Banks appointed as ACCDs can also provide several foreign currency services for domestic clients, such as financing and deposit services in the partner currency and currency hedging to manage exchange risks between the two currencies.

The LCSF was initiated by the Bank Negara Malaysia (BNM) and the Bank of Thailand (BOT), in March 2016. Under this framework, eligible international transactions for local currency settlement were limited to trade in goods and services, three banks were designated as ACCDs in each country, and direct exchanges of the ringgit and baht were introduced in interbank markets. Then Bank Indonesia (BI) joined the framework in December 2017 and the BNM-BOT-BI LCSF was officially launched, effective January 2018. Eligible transactions for ringgit-rupiah and baht-rupiah settlements were limited to trade in goods and services initially, while the Malaysian and Thai central banks agreed to expand eligible transactions for ringgit-baht settlements to include FDI. The three central banks designated their commercial banks as ACCDs for each of the two pairs, i.e., BI-BNM and BI-BOT on bilateral bases, while the Malaysian and Thai central banks enlarged their lists of ACCDs.

Furthermore, The Philippines central bank, Bangko Sentral ng Pilipinas (BSP), signed three separate letters of intent on LCSF with BI, BNM, and BOT in April 2019, with the next step being to identify ACCDs to conduct cross-border settlements and associated currency exchanges. In the meantime, the BI-BOT LCSF was expanded in December 2020 to include FDI in eligible transactions, add more commercial banks as ACCDs in each country, and further relax foreign exchange rules and regulations, such as allowing flexible documentation requirements. Several objectives motivate the introduction and development of the LCSF. The most important are to promote home currency use in cross-border trade and FDI settlements, reduce the risks from dependence on the dollar, and to achieve greater economic and financial stability.

Over-reliance on the dollar for conducting international transactions would make countries vulnerable to rapid swings in US monetary policy and dollar liquidity shortages during times of global financial market stress. Thus, the use of regional currencies in trade and investment would mitigate such risks and contribute to the



diversification of international settlement currencies. Another objective is to stimulate trade and investment and economic growth by reducing currency risks among LCSF participating countries. A final objective is to help deepen economic and financial integration in ASEAN. This is in line with the ASEAN Economic Community (AEC) 2025 Blueprint, which aims to stimulate intra-ASEAN trade, investment, and connections among the region's commercial banks. Finance sector integration is central to AEC building under the Blueprint.

For some ASEAN countries, LCS has a significant impact on international trade and FDI. In 2022, international trade using LCS in Indonesia grew to USD3.8bn, rising 50.2% from 2021's USD2.5bn. The achievement of transactions through LCS in 2022 is a significant increase compared to the pandemic period which only amounted to USD797mn. The LCS agreement in the ASEAN region will continue to be implemented into a wider range of international trade transactions.

In conclusion, to further strengthen and deepen ASEAN connectivity through physical, trade, and investment & financial, concerted efforts are required for member countries to play a part in it. This note seeks to increase further understanding of the potential benefits going forward to bring about higher and more quality as well as sustainable growth for ASEAN. Towards this end, further enhancement towards higher and greater intra-ASEAN trade and higher utilization of LCS are crucial to bring about higher welfare for ASEAN.

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