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**REGIONAL
OUTLOOK**
Southeast Asia
2008–2009

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REGIONAL OUTLOOK

**Southeast Asia
2008–2009**



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PREFACE

The first *Regional Outlook* had its inception in 1992, offering a concise analysis of the political and economic trends in Southeast Asia and the wider region. Since then, an annual succession of this publication has tracked many political and economic developments and their implications on the region.

This year is no different, with emerging political and economic trends that warrant scrutiny. Written in an accessible and scholarly style, this publication is suited for a modern audience of business and research analysts, busy executives, professionals, diplomats, journalists, and interested observers. *Regional Outlook*, over the years, has managed to build up a loyal readership within Southeast Asia and beyond.

The year 2007 was a historic one for the Association of Southeast Asian Nations (ASEAN) in that the ASEAN Charter was signed by all member countries at the ASEAN Summit in Singapore in November. When ratified by all countries, this document will garner positive political, economic, and social benefits for the region. An ASEAN Economic Community will be formed by 2015, effectively unifying ASEAN into a single market. The implications in the years to come, though not during the period 2008–2009, will be significant.

In socio-political terms, the charter is a landmark as it sets out rules for good governance, democracy, and the rule of law in ASEAN countries. The establishment of a human rights body is a development that could not have been anticipated even a few years ago, and illustrates the maturity with which ASEAN is confronting the challenges of our times.

On the economic front and closer to the horizon of 2008 and 2009, growth will be modest at best for the Southeast Asian region because of the economic slowdown of the U.S. economy.

High oil prices remain worrisome, and this will be a negative factor for the growth prospects of ASEAN economies. The U.S. sub-prime mortgage market disrupted global financial markets in 2007, and though perceived by observers to be short-lived, has affected not only U.S. growth prospects in 2008, but is also likely to impact Southeast Asian economies. The economic outlook for ASEAN in 2008 and 2009 will, therefore, depend on how governments manage their domestic economic affairs given the policy instruments at their disposal to cope with the slowdown in the United States, Japan, and EU economies.

The notable political trends that will be closely observed in 2008–2009 include the outcome of the presidential elections in the United States and the policy and ideational shifts that may arise from either a Democratic or Republican administration. International pressure will remain strong on Myanmar. Nudging the military government into action and reform will be a major challenge for ASEAN in the coming year. The situation in Thailand will also be closely watched as the country holds its first national elections since the September 2006 coup. At the time of writing, it appears that the future government will be a coalition of different parties, and it is hoped that this will bring a measure of stability to the country.

Regional Outlook 2008–2009 was written by a team from within and also outside the Institute. A few new writers have given fresh perspectives to forecasting developments in the region. I wish to thank the editors as well as all the writers for their hard work and their contributions.

K. Kesavapany

Director

Institute of Southeast Asian Studies

7 December 2007

INTRODUCTION

Karl Popper's famous metaphors of "clouds" and "clocks" are often invoked to describe the nature of the social world, and the degree to which it lends itself to that much-celebrated goal of prediction. While some conceive the social world as clouds, implying contingency and unpredictability, others have attributed to it the properties of a clock, indicating the possibility of absolute regularity and predictability. Even though predicting for the social world has been a problematic exercise, it has nevertheless been possible to tease out trends, identify emerging phenomena, and make qualified analysis that consider both contingency and predictability. *Regional Outlook*, published since 1992, is an attempt at formulating nuanced assessments of complex political-economic processes that, in this case, are at work in Southeast Asia.

The politics of this region is not only a product of domestic political processes but also of the international politics of its external environment, specifically that of East Asia. In the period ahead, a few external dynamics would be more noticeable than others. The presidential election in the United States is one among them. While a new Democratic administration in 2008 may seem a strong possibility, it is still far from being a foregone conclusion. Either way, the trenchant neo-conservatism that has clouded sections of the U.S. foreign policy elites under the Bush administration will come under increasing strain. While this may impact on U.S. policy towards Iraq and Iran, it is unlikely to have any radical impact on U.S. policy in East Asia, where America's alliances will continue to strengthen with Japan, South Korea, Australia, and some Southeast Asian countries. Strategic concerns regarding China will also persist, and a new administration is likely to continue with a formula of engagement, pragmatism, caution, and the occasional rhetoric on rights and democracy.

An increasingly important external dynamic that will occupy the attention of Southeast Asia in the coming years is the rising strategic presence of China and India in this region. Both powers have stepped up commercial and strategic initiatives. While China's economic clout remains dominant, India's "Look East" policy has led it to promote its naval power along with robust cultural "soft power" initiatives. This dynamic is explored in detail in the two thematic chapters in this year's *Regional Outlook*.

These trends, coupled with the promising turn of events on the Korean Peninsula and relative harmony in the South China Sea, indicate that the external security environment in East Asia is likely to remain stable. However, heightened polarization between the Democratic Progressive Party (DPP) and the Kuomintang in the build-up to presidential elections in Taiwan, and the latent possibility of changes in political identity, will test China's sensitivities in the year it hosts the Olympics. Considering the profound bearing that the U.S.-Taiwan relationship has on Asia's perception of America's commitment to its alliances in the region, and the unpredictable pulse of Taiwanese democracy, the period around March 2008 is potentially one of pressure and strain in the international politics of East Asia.

Besides the international, there is also a regional level of analysis that has to be considered in assessing Southeast Asia. The Association of Southeast Asian Nations (ASEAN) took the significant step of signing a charter in its fortieth year. The charter indubitably marks the organization's transition to a rules-based legal entity from one that had hitherto operated primarily through consensus. Apart from setting out rules for economic integration, it also valorizes the cause of democracy, good governance, and human rights. While the setting up of a human rights body has been unprecedented, its terms of reference remain unsettled.

Criticisms of ASEAN persist, but the new charter at the least indicates a greater sense of purpose among ASEAN elites over the future they seek to realize for the region. While the 14th ASEAN Summit in Singapore ended on a high note, there will be some major challenges over the coming year: ratification of the charter in individual countries, the pressing need to engender an ASEAN identity rooted

in popular, grass-root discourses, and, of course, the formulation of a more effective policy towards Myanmar, especially since ASEAN's international image and credibility had been tested by the persisting Myanmar problem.

The threat posed by two of the principal regional security concerns — terrorism and maritime piracy — was mitigated in the course of 2007. The instances of piracy and armed robbery at sea in the Malacca Straits — of crucial import to commerce in Southeast Asia — fell from previous levels recorded in 2006, thanks in large measure to coordinated naval patrols by Indonesia, Singapore, and Malaysia over the past few years. Terrorism, especially the millenarian strand of Jemaah Islamiyah (JI), was constrained by police and law enforcement action, especially in Indonesia, in 2007. Continued crime enforcement, assisted by the emergent ideological and moral rifts within JI cadres, will further weaken the millenarian terrorist threat in the coming year, though the unpredictable nature of such violence precludes any definite forecasting.

Separatism and insurgencies within states will pose, however, a greater challenge to security in the coming year. Violence in the three southern provinces of Thailand was persistent through 2007, and with the insurgency well entrenched, the security situation there is likely to remain unstable in 2008. Armed conflict will also continue in the southern Philippines in 2008, with the Armed Forces of the Philippines coming down especially hard on the Abu Sayyaf group and the New People's Army.

The year 2007 witnessed the dramatic securitization of climate change in international political and environmental discourses, and Southeast Asia was no exception to this trend. Linking resource scarcity, induced by changing climate patterns, with conflicts is causing rising concern, and climate change is set to grow as a major policy agenda. Indeed, at the 2007 ASEAN Summit, leaders issued a joint statement pledging support for the outcomes arising from the United Nations Framework Convention on Climate Change (UNFCCC), which will provide a blueprint that could replace the Kyoto Protocol that expires in 2012.

Domestic politics, expectedly, is set to be tumultuous in some states of Southeast Asia and stable in others. The *Regional Outlook* in 2007

forecasted the strengthening of the Cambodian People's Party (CPP) and Prime Minister Hun Sen, and this was demonstrated in their success in the commune elections in April 2007. The CPP is set to further consolidate its power in the country with parliamentary elections in July 2008, which is very likely to result in a CPP government headed by Hun Sen.

Preparations for national elections will gather pace in Indonesia and Malaysia, with the former holding parliamentary and presidential elections, and the latter parliamentary elections, in 2009. In Indonesia, political manoeuvring began in 2007, with PDI-Perjuangan seeking to draw Golkar into a future coalition, and with talk of new candidates for presidential elections, in particular, the current Vice-President Jusuf Kalla. Meanwhile, anti-establishment pressures have been on the rise in Malaysia, fuelled by the perception of rising corruption, weak leadership, racial polarization, among others.

While some countries in the region, such as Brunei, Singapore, Laos, and Vietnam, are unlikely to experience anything dramatic, the situation is substantially different for other nations in Southeast Asia.

Myanmar was at the centre of international attention with large anti-government protests that began in August. These were violently suppressed in September 2007. The junta has weathered the domestic unrest and international outcry, and will pursue national reconciliation through its seven-step "road map for democracy", which has entered its third stage with a drafting commission beginning to write a constitution that will only further secure military power in the country.

Elections that will mark Thailand's hopeful transition from military to civilian rule will take place on 23 December 2007. While Thaksin loyalists, regrouped as the People's Power Party, are likely to do well in the elections, they may not obtain a clear majority. Thailand is thus likely to see a reversion to the weak coalition governments of the past. This weakness will also stem from the new constitution that favours the ruling elite. With different factions of the powerful Bangkok elite — comprising royalists, the military, the bureaucracy, political parties and civil society — continuing to exercise influence, the political situation in the country may remain unpredictable in 2008–2009.

Current trends suggest a complex outlook for the Philippines. Elections in May 2007 saw the Arroyo coalition obtaining a majority

in the Lower House, thus making impeachment efforts against the administration untenable in the near future. That, however, does not preclude strong political challenges for President Arroyo, with her government facing a crisis of legitimacy and credibility, mainly on account of long-standing corruption charges and allegations of cheating in the 2004 elections. The seriousness of the latter is evidenced from the failed coup by rebel soldiers in Manila on 29 November 2007, making this the fourth attempted coup during Arroyo's presidency since 2001.

All these trends and much more are fleshed out in the ten country chapters that appear in the political section of this volume.

Economic growth is likely to continue in the region, but with less robustness compared to what was enjoyed in 2007. Higher oil prices in 2007 are expected to persist throughout 2008, and will certainly put a dampener on the growth prospects of all ASEAN economies, with the exception of Brunei Darussalam's economy, which is predominantly dependent on oil exports.

The weakening U.S. currency is also a worrying factor that will affect growth prospects in Southeast Asian economies. A lower U.S. currency would also mean that the United States could not continue to rely on foreign currencies to finance its current account deficits. Other challenges in this region include the potential spread of bird flu which has not been much on the radar in recent months, but which potentially could be damaging on economies if an epidemic emerges in 2008 or 2009 and is not contained and managed.

A slowdown in the U.S. economy in 2008 will affect the growth trajectory of Southeast Asian economies during the forecast period. The impending slowdown will be experienced because of persistently higher oil prices, and a general weakening of the confidence in the U.S. dollar. The impact of this slowdown will, however, get buffered by demand from the robust Chinese and Indian economies and also to a smaller extent by the Japanese and EU economies, which are expected to grow but at slower rates in 2008 and 2009. Although growth rates will be slower in the Asian economies, they will nevertheless continue to be in positive territory.

The potential bursting of the bubble in the U.S. housing market which was discussed in last year's *Regional Outlook* publication has

manifested itself in the form of the sub-prime mortgage crisis this year which has had ramifications not only in the United States but in stock markets throughout the world.

The sub-prime mortgage crisis, if not properly managed by the United States government, would have widespread ramifications on domestic U.S. consumer demand, one of the chief drivers of its economy. Weaker consumer demand could result in recessionary forces that would not bode well for ASEAN economies as well as other major economies dependent on the U.S. market. The real economy appears more resilient, but equity and financial markets in Southeast Asia will likely remain fuzzy if sub-prime woes continue in 2008, this ultimately impinging on the real economy.

Exports will continue to play an important role for Southeast Asia. Current account surpluses are expected to remain in the positive domain, though it is likely to be lower in 2008 and 2009 due to more rapid imports of raw materials, and intermediate and capital goods into ASEAN economies. Inflation is expected to remain steady but is likely to edge up if governments in the region do not use the appropriate macroeconomic policies to manage price pressures, especially in view of the continuing high oil prices.

On a positive note, the signing of the ASEAN Charter and the road map towards realizing the ASEAN economic community and a single ASEAN market by 2015 is promising and significant, though its benefits are not expected to immediately filter into the growth prospects during the forecast period.

The prospect of the various FTAs to be signed between ASEAN and China, India, Japan, Korea, and various other nations looks promising, though once again, this is not likely to have an impact on regional economies during the forecast period.

In the two years ahead, growth will remain positive for Brunei Darussalam with rates expected to be around the 2 per cent mark. Higher oil prices bode well for the Bruneian economy; however, the economic robustness of Brunei's trading partners will be affected and this will in turn affect Brunei's economy.

Growth in Cambodia has been nothing short of spectacular with robust growth expected to continue in 2008 and 2009. Changes in the foreign direct investment policies of the country have improved

its business climate but corruption, high electricity costs, and a poor infrastructure remain issues that will affect the growth prospects.

Positive developments will likely continue to fuel Indonesia's economic growth, with business and consumer confidence improving. Indonesia's financial economy has shown resilience to the U.S. sub-prime mortgage crisis up to the third quarter of 2007. This is a promising development compared to the crisis that occurred in 1997. Indonesia has also had a strong current account surplus, because of remittances from Indonesian workers overseas and strong exports. Growth in 2008 and 2009 is expected to be better than that of 2006.

Growth prospects in 2008 and 2009 in the Lao PDR is likely to continue to be driven by gold and copper mining (Sepond and Phoubia mining projects) and construction of large infrastructural projects like the Nam Theun 2 hydropower project. In addition, prudent fiscal and monetary policies, and SOE reforms will be factors providing for the positive growth forecast.

Malaysia's growth is likely to be underpinned by robust domestic demand, a strong services sector, and continued strong exports (although this will be less robust especially for electrical and electronics products). In addition, the development of the Iskandar Development Region will bode well. However, the downsides that will dampen growth are the U.S. sub-prime mortgage crisis and the record level high price of oil.

Modest economic growth is expected to continue in Myanmar of around 4 to 5 per cent, with economic and political instability of the crackdown in 2007 affecting the economic outlook during the forecast period. The tourism sector especially has been badly affected by this recent crackdown with a severe downturn in hotel occupancy rates as well as the halting of flights from the national airline, the Myanmar Airways International. The downturn in the tourism sector is expected to continue into 2008. Overall, the negative climate is expected to pervade in 2008 and will impact negatively on growth.

Growth forecasts remain positive for the Philippines, with macro-economic conditions expected to remain favourable towards inducing growth. Real GDP growth in 2008 and 2009 will however be lower than that of 2007, with private consumption and electronic exports expected to remain the main drivers of the economy. The lack of private investments remains a sore point that would potentially be

one of the factors preventing the economy from growing above the forecasted rates. Lower inflation and interest rates, however, are a plus for the economy.

The Singapore economy has successfully diversified into several growth engines — pharmaceuticals, biomedical, financial services, construction, and tourism, sectors less sensitive to the U.S. business cycle, which is expected to be on a downturn in 2008. Nevertheless, high oil prices and their impact on manufacturing costs remain worrisome. Supply bottlenecks were also faced in certain sectors of the Singapore economy in 2007 resulting in increasing pressures on inflation, business costs, labour market costs, and high rental and property prices. This accelerating inflation rate, higher business and labour costs, and rising rentals and prices in property markets, which figured prominently in 2007, are factors that will affect growth in 2008 and 2009.

Growth rates for the Thai economy in 2008 and 2009 will be largely determined by the formation of a stable coalition government, the government's ability to jumpstart investments, and the global economic environment. Thailand's economic growth has been largely export-driven and will continue to be so. Investments, both private and public, are expected to stage a meaningful recovery in 2008 and 2009, bringing healthy prospects for Thailand's growth.

Vietnam's growth trajectory remains strong at over 8 per cent per annum in 2008 and 2009. Foreign investor interest have continued in the country. However, inflation and a stubborn trade deficit are the only worrying factors.

The thematic boxes in the Economic Outlook section take a serious look at regional economic integration and the ASEAN Charter, energy and environment, the evolving regional financial architecture in East Asia, and the economic corridors in the Greater Mekong Subregion. Such developments potentially have implications when considering the medium and longer-term trends in regional development and growth.

Deepak Nair
Lee Poh Onn
Editors

7 December 2007