ASEAN Research Digest

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VOLUME 2 | ISSUE 2 | MAY 2013

The ASEAN Research Digest is a bimonthly publication aimed at communicating research findings related to ASEAN integration, cooperation and development that are relevant to business and industry in anticipation of the formation of the ASEAN Economic Community in 2015.

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ASEAN BANKS LAG BEHIND THEIR FOREIGN COUNTERPARTS IN REVENUE DIVERSIFICATION

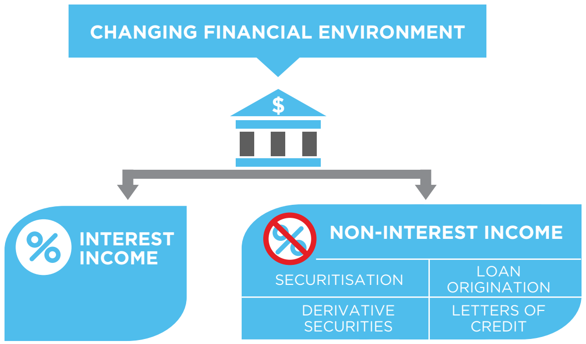
Title of study: Bank market power and revenue diversification: Evidence from selected ASEAN countries

By My Nguyen, Michael Skully, Shrimal Perera | Published in: Journal of Asian Economics, Volume 23, 2012

BACKGROUND

Research objectives:
To explore the influence of bank market power on non-interest income

- Limited research has been done until now on which bank characteristics, industry and/or market conditions are associated with an increase in non-interest income.



- The authors believe the relationship between bank market power and non-interest income to be non-linear because **the incentive to diversify income decreases as bank market power increases**, because the bank can generate sufficient profits by pricing above marginal cost.

- The ASEAN region was chosen because of the unique bank restructuring and regulatory changes implemented by ASEAN countries following the Asian financial crisis (AFC) and later due to integrating efforts of ASEAN.

METHODOLOGY

- The data sample covers 153 commercial banks operating in five ASEAN member countries:
  - Indonesia
  - Malaysia
  - Philippines
  - Thailand
  - Vietnam

- Overall, the sample consists of 992 bank-year observations over the period 1998-2008. To avoid survivorship bias, the data covers as many banks as possible, including those not operating over the entire sample period.

- Bank revenue diversification is calculated as the ratio of net non-interest income as a percentage of total assets.

- Bank market power is proxied by the funding-adjusted Lerner index, which is defined as the disparity between price and marginal cost expressed as a percentage of price.

$$\text{BANK POWER} = \left[\frac{\textit{PRICE OF TOTAL ASSETS} - \textit{MARGINAL COST OF TOTAL ASSETS}}{\textit{PRICE OF TOTAL ASSETS}}\right]$$

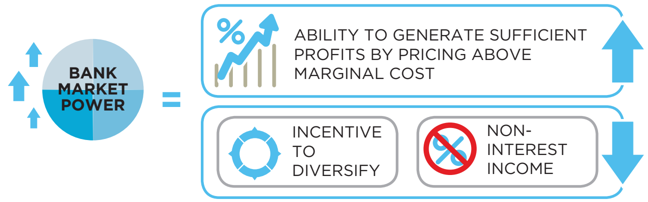
The divergence between the product price and the marginal cost of production implies monopoly power. The funding-adjusted Lerner index includes only operating costs and the price of physical capital but excludes financing costs, since deposit market power is already incorporated in loan pricing through the premium.

KEY FINDINGS

- Banks with lower market power in loan and deposit markets focus more on new growth opportunities and have higher non-interest income. Banks with greater degree of market power concentrate more on traditional interest-based products.

- Credit losses experience by banks because of the AFC encouraged ASEAN banks to diversify their income by non-interest activities to compensate for their losses. When markets recovered and loan demand increased, the banks refocused their activities on the traditional interest-based business.

- ASEAN banks with higher capital ratios appear to have higher levels of non-traditional activities.



- The findings provide important implications:

For bankers

Domestic ASEAN banks lag behind their foreign counterparts in earning non-interest income. Banks should invest more in the necessary expertise to increase their non-traditional income and they should also lobby the regulators to relax activity restrictions.

For investors

It is important for investors to select banks with good revenue diversification strategies because traditional interest-based activities and non-interest rate activities have different risk implications

For regulators and policy makers

It is beneficial to relax activity restrictions and allow ASAN banks to diversify their product offerings. They should however monitor non-traditional activities since they can be associated with increased overall bank risk.

WHY IT MATTERS

Growth potential for ASEAN banks could lie in non-traditional banking products that generate non-interest income. Revenue diversification can also be, as the findings suggest, especially important for banks during recessions. However, non-traditional income generating products need to be monitored by regulatory authorities, as they involve more risk than traditional interest-based income activities. This was evident during the global financial crisis, when western banks that were heavily involved in non-traditional activities such as securitisation were far worse hit than ASEAN banks that rely more on traditional interest-based revenue.

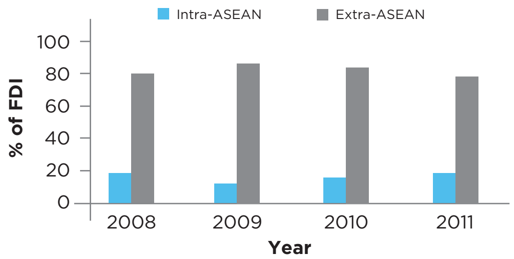
2 AIA HAS POSITIVE EFFECTS ON INTRA-ASEAN FDI BUT IS LESS BENEFICIAL TO LOCAL ENTREPRENEURIAL COMPETITIVENESS

Title of study: Promoting intra-ASEAN FDI: The role of AFTA and AIA
By Tajul Ariffin Masron | Published in: Economic Modelling, Volume 31, 2013

BACKGROUND

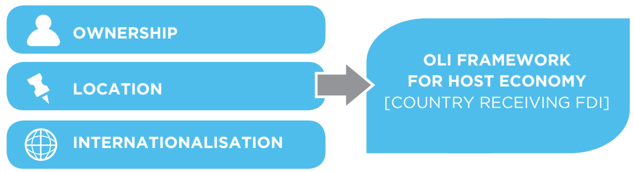
Research objectives:
To investigate contributing factors to intra-ASEAN FDI, especially the roles of the ASEAN Investment Area (AIA) and the ASEAN Free Trade Agreement (AFTA).

- Policy makers of many countries try to attract Foreign Direct Investment (FDI) to their country as a part of their long-term economic development strategy because FDI has proven to play a vital role in economic development.
- Intra-regional investment has become increasingly important in ASEAN as growth of external FDI has slowed due to the global financial crisis

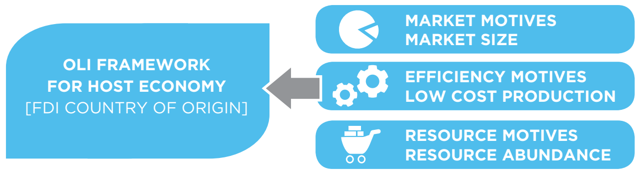


METHODOLOGY

- To explore intra-ASEAN FDI, the authors use the eclectic model, which usually is comprised of three main factors:



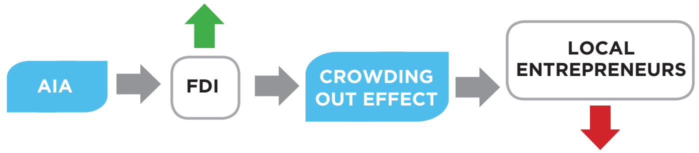
- The OLI framework is mainly applicable for the host economy – since the authors focus their study on the home economy, they redefine the OLI framework to capture the motives of Multinational corporations (MNCs) to move their production abroad



- In addition to these variables, the authors test the effect of the AIA and AFTA on intra-ASEAN FDI with the use of proxies.
- The data is limited to the ASEAN-9 and covers the period between 1998 and 2009.
- The authors chose to use the dynamic panel technique, which is the fully modified ordinary least squares (FMOLS), because of the short time span of the data and potential endogeneity issues.

KEY FINDINGS

- Overall, the findings suggest that the AIA has had positive effect on intra-ASEAN FDI.
- However, the results suggest that the development of local entrepreneurs in ASEAN is not very impressive, which could be due to a crowding-out effect of foreign capital.



- The results also imply that the bulk of FDI into the region from other countries is either resource-seeking or efficiency-seeking, which means that MNCs are expected to relocate if the region or any of its members loses its competitiveness in either or both of these aspects.
- However, intra-ASEAN investment is not very resource-seeking. This could be because firms are more concerned with high political risk in those resource rich ASEAN countries and prefer to invest abroad in more stable political environments.
- Furthermore, the result show that lower trade barriers among ASEAN members reduce MNCs desire to relocate as their products can easily be exported to other ASEAN members without huge additional cost.
- Finally, the results show that even while production cost has been rising in the ASEAN region, productivity has increased as well, keeping the region's competitiveness.
- On a final note, the author recommends that governments form national policies to help elevate local entrepreneurs to become regional players as a part of a long run economic strategy for the region.

WHY IT MATTERS

This study shows that while AIA has proved effective to promote intra-regional investment, the development regional investors is still lacking and could use government support, especially at this crucial time when foreign FDI has decreased due to the global economic crisis.

3 ASSISTING MSME'S TO ACHIEVE THEIR POTENTIAL IN INDONESIA

Title of study: Promoting SME Developments in Indonesia
By Annabelle Mourougane | Published in: OECD Economics Department Working Papers No. 995, 17 October 2012

BACKGROUND

Research objectives:
To identify ways that small firms can make their fullest contribution to job creation and productivity to attain sustainable growth over the long term.

- Micro, small and medium-sized enterprises (MSMEs) are a key source of employment and economic growth in Indonesia, but many MSMEs have low productivity.

MSMEs Represent {
99% of Firms
97% of Employment
57% of value-added
<50% of Investment
} in Indonesia

- MSMEs were a key factor in maintaining household income during the global financial crisis and have played a big role in the decline of poverty in Indonesia. This could be due to the low reliance of micro and small firms on formal markets and credit allows them to respond quickly to shocks.

- Middle sized firms account for only a tiny part of MSMEs. This so called "missing middle" in the production structure is common in Southeast Asia.
  - Micro enterprises dominant in the agricultural sector
  - Small enterprises dominant in the trade and hotel sectors

- SMEs generally have a lower propensity to export than larger firms, but SMEs' share of non-oil exports in Indonesia have been declining since 2008 and now represents less than a fifth of all non-oil exports.

- Indonesian SMEs are largely run in the informal sector; the percentage of SMEs with formal registration is lower in Indonesia than in Cambodia and Vietnam.

- Labour productivity is significantly lower in MSMEs compared with larger firms. This can be explained by the fact that smaller companies usually use manual modes of production, lack skilled workers and IT processes, have outdated machinery, and lack the know-how to improve methods of production.

2009 - 2010

SIZE OF FIRM	MICRO	SMALL	MEDIUM	LARGE
GDP PER EMPLOYEE IN IDR (MILLIONS)	0.8	6.5	11.6	32.9

METHODOLOGY

The analysis relies on a wide range of databases. When possible, the analysis focuses on the broader concept of MSMEs but in some cases the analysis only covers small and medium-sized firms.

KEY FINDINGS

International evidence show that a large SME sector is correlated with strong GDP per capita growth, but increasing productivity is necessary for the job creation by SMEs to translate into long-term growth.

The authors suggest three ways to stimulate SME productivity growth:
1. Encourage formalisation
2. Increase the pool of qualified workers
3. Remove obstacles to investment and facilitate SME growth

1. Encouraging the formalisation of small firms
- According to the World Bank, only 25% of small firms legally register when they start operating in Indonesia.
- International evidence shows that productivity is higher in the formal sector as firms enjoy easier access to finance.

The author suggests:
a. Reducing red tape
b. Simplifying tax procedures
c. Limiting the rise in labour cost

2. Increasing the availability of qualified labour
- Lack of qualified workers can inhibit productivity growth, especially as the economy moves toward a knowledge-based economy.
- A 2010 World Bank skill survey shows that only 7% of senior education graduates are rated as 'very good' while most are consider only 'fair', and 40% of employers think their staff lacks thinking, behavioural, and vocational skills.
- Indonesia lags behind its regional peers in secondary and higher education despite significant improvements in enrolment rate in the past decade

The author suggests:
a. Allocating additional government spending to condition secondary school attendance in income support programs to reduce the number of drop-outs
b. Improve the capacity of public training centres and improve their curriculum to serve local firms' skill needs
c. Monitor the progress in teaching quality through regular assessments of teachers
d. Focus the curriculum of vocational schools to transferrable skills such as computer literacy
e. Grant more autonomy to tertiary education institutions so that they can more easily adapt to firms' skill requirements and ensure quality teaching
f. Create a range of cost sharing instruments to alleviate the financial burden of poor students
g. Create a national training fund to consolidate resources allocated to training and direct them to their most cost-efficient use

ASSISTING MSME'S TO ACHIEVE THEIR POTENTIAL IN INDONESIA

Title of study: A framework for analysing intergovernmental collaboration – The case of ASEAN tourism
By Emma P. Y. Wong, Nina Mistilis, and Larry Dwyer | Published in: Tourism Management, Volume 32, Issue 2, 2011

KEY FINDINGS

3. **Stimulating SME investments**
   - Lack of access to finance is the main impediment to investment for Indonesian SMEs.
   - Non-performing-loan ratios indicate that the quality of loans to small firms compares favourably with conventional loans, but bank loans are still concentrated in the trade and service sectors; SME loans account for only 21.6% of total loans.

Following ASEAN's SME development roadmap, Bank Indonesia and the Ministry of SME and Co-operatives are planning to develop an SME-specific credit scoring system later this year

END OF 2011

SIZE OF FIRM	MICRO	SMALL	MEDIUM	LARGE
IDR (BILLIONS)	102,905	150,912	226,069	479,887
% OF TOTAL LOANS	4.6	6.8	10.2	21.6

WHY THE LACK OF ACCESS TO FINANCE?	THE AUTHOR SUGGESTS:
Lack of collateral is a major deterrent to credit access, exacerbated by poorly defined property rights	• Improve borrowers' property rights to assets they could pledge as collateral • Following ASEAN's SME development roadmap, Bank Indonesia and the Ministry of SME and Co-operatives are planning to develop an SME-specific credit scoring system later this year • Strengthen creditor rights to reduce the risk of future losses, which is especially important given Indonesia's weak judicial system. Provide credit guarantee to MSMEs' loans, either by the government or special credit-guarantee companies
Asymmetric information impedes SMEs' access to finance, as banking institutions overestimate the risk of MSME lending and charge higher rates or are reluctant to lend at all.	• Establish credit registries that provide reports on firms' loan repayment history to reduce processing time, costs and default rates
The banking sector is concentrated in big cities and it is difficult to open new rural banks	• Reconsider policies that hamper market entry of new banks • Ease restrictions on rural banks, such as the restriction on foreign ownership of rural banks and restrictions for opening new branches
The stock market remains shallow and small companies have been reluctant to go public	• Less onerous reporting and disclosure requirements for small firms would make Initial Public Offerings an attractive option for financing

Poor infrastructure is another major factor influencing investment decisions.
- Transportation costs in Indonesia account for around 30% of total production costs due to poor infrastructure.
- Almost half of the 13,000 companies surveyed in 2010 and 2011 experienced power blackouts at least three times a week – Indonesia ranked at 161 out of 183 countries in the ease of businesses' getting reliable electricity supply in a 2011 World Bank report.

The author suggests:
a. That the increase in public spending on infrastructure be accompanied by additional reforms such as improving regulation, and improving co-ordination between national and local authorities
b. That for the electricity sector, the government should phase out its electricity subsidies

Innovation could be a major source of SME productivity improvement, but evidence shows that small firms in Indonesia appear to innovate less and have less access to new technology than their ASEAN peers
- Strong intellectual property rights (IPR) would encourage innovation but Indonesian SMEs currently rely more on informal ways such as trust and secrecy to protect their intellectual property
- It is costly to monitor infringement of IPR and Indonesian companies often do not trust the IPR enforcement mechanisms

The author suggests:
a. To follow up and allocate more resources to improve enforcement of IPR regulations
b. That policies reduce the time and cost of enforcement procedures and improve SMEs confidence in the process

WHY IT MATTERS

Improving SME's productivity will become increasingly important as ASEAN moves towards the ASEAN Economic Community in 2015, and with the implementation of free trade agreements with China and India, which will make Indonesian firms face stronger competition in the domestic market.

4 OPEN MARKETS LEAD TO MORE FOOD SECURITY

Title of study: Agriculture and Food Security in Asia by 2030

By Kym Anderson and Anna Strutt | Published in: ADBI Working paper no. 368, July 2012, Asian Development Bank Institute

BACKGROUND

Research objectives:
To explore the impact of growth in emerging Asia on the agricultural market and food security.

- The rapid economic growth in emerging Asia - especially in ASEAN, China, and India (ACI countries), has increased the importance of the region in the world's output and trade.
- As income increases, consumption patterns change and demand for cereals, livestock, and horticultural products rises.

- This growth has a significant impact on food and energy security as ACI countries combined account for nearly half of the entire human population.

> "Food security is when all people, at all times, have physical, social and economic access to sufficient, safe and nutritious food which meets their dietary needs and food preferences for an active and healthy life - The United Nations Food and Agriculture Organisation

METHODOLOGY

- The paper summarises theoretical expectations and historical lessons from previous generations of Asia's industrialising economies, and then projects the world economy to the year 2030
- The authors use the GTAP (Global Trade Analysis Project) model of the global economy and Version 7.1 of the GTAP database which is calibrated to 2004 levels of production, consumption, trade and protection.
- The standard GTAP model is a widely used Computable General Equilibrium (CGE) model and the base period of 2004 is ideal because it precedes the food price spikes in 2008 and the recent financial crisis.
- The results of a core business-as-usual projection are compared with the results of projections based on alternative assumptions regarding sectoral productivity growth rates and trade policies

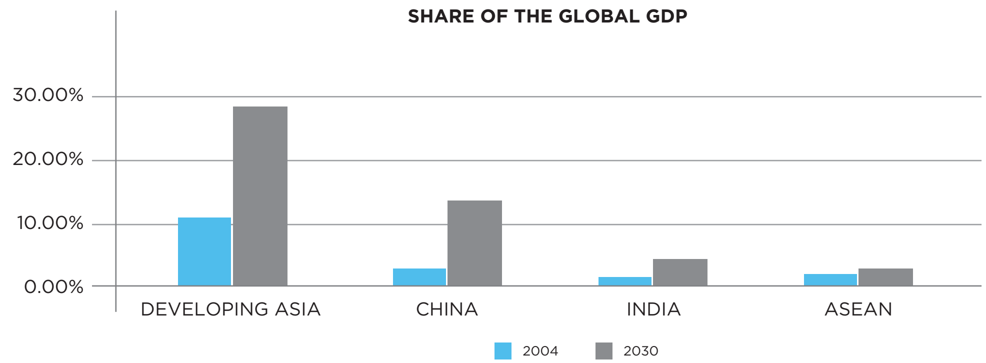
METHODOLOGY

- **Alternative Scenarios**

FOUR DIFFERENT SCENARIOS			REASONS
Two alternative growth scenarios to 2030	1	Slower global productivity growth in primary sectors	To see the impact of higher relative price of primary products
	2	Faster grain productivity in China, India, and ASEAN due to domestic agricultural R&D	To see the impact of policies aimed at slowing the rise in food and grain import dependence
Two alternative trade policy scenarios to 2030	3	Partly or fully opened regional goods markets	To see how current Asian trade policies are affecting trade and food self-sufficiency in the region and elsewhere
	4	All developing countries' agricultural import tariffs are raised towards their legal limits	To see how such beggar-thy-neighbour policies would impact Asian food security

KEY FINDINGS

- Developing Asia's share of the global GDP is projected to have tripled by 2030. China's and India's shares more than triple by 2030, with China reaching 14.4% of global GDP from 4.1%, and India 5.3% from 1.6%. ASEAN's growth is not as extreme with its share rising from 2% to 3.5% over the period.



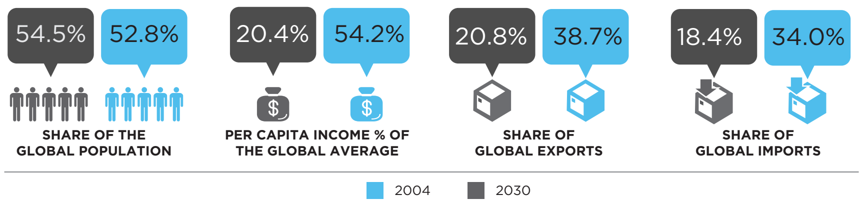
OPEN MARKETS LEAD TO MORE FOOD SECURITY

Title of study: Agriculture and Food Security in Asia by 2030
By Kym Anderson and Anna Strutt | Published in: ADBI Working paper no. 368, July 2012, Asian Development Bank Institute

KEY FINDINGS

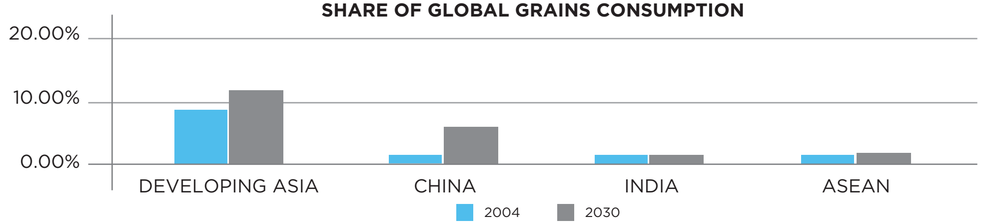
- Developing Asia's share of the global population decreases slightly and the per capita income more than doubles. The region's share in trade also increases significantly, accounting for more than a third of total world trade by 2030.

DEVELOPING ASIA



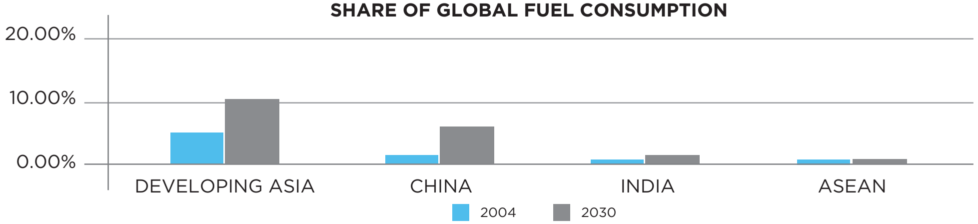
- By 2030, developing Asia will consume nearly 60% of the world's grain production. China's share increases significantly and will account for a quarter of global consumption by 2030. ASEAN's share increases only slightly and India's share decreases by one percentage point, both hovering around 10% of global grains consumption.

SHARE OF GLOBAL GRAINS CONSUMPTION



- By 2030, developing Asia will account for more than half of the world's fossil fuel consumption. China's share increases from nearly 10% to over 28%, India's share triples from 3.6% to 11.3%, while ASEAN's share increases only slightly from 4.5% to 5.5%.

SHARE OF GLOBAL FUEL CONSUMPTION



- India's agricultural self-sufficiency ratio is projected to remain constant over the period at around 100% self-sufficiency. ASEAN's agricultural self-sufficiency ratio is expected to decrease from 97% in 2004 to 85% in 2030, while China's ratio is expected to decrease from 97% to 83% over the period.

- **Key findings of scenarios**
  1. Slower productivity growth in primary product sectors leads to real international prices for farm products to be 25% higher than in 2004 compared with only 9% in the baseline scenario. This does not lead to more food self-sufficiency among developing countries nor increases their share in global trade in primary products. The higher prices do however raise the share of GDP that is traded by each region.
  2. Faster productivity growth for rice, wheat and coarse grains in ASEAN, China and India would raise overall agricultural self-sufficiency rates by 3% in ASEAN, 1% in India but would lead to a slight decrease in China due to lower international prices. It would also slightly increase agricultural trade among ACI countries.
  3. Opening trade within the ASEAN+6 (ASEAN plus China, Japan, South-Korea, India, Australia, and New Zealand) would go a long way in generating the benefits of a global goods trade liberalisation due to the size of these economies. ACI's share of the world's agricultural exports in 2030 would be 17% instead of 12% in the core model and agricultural imports would be 38% instead of 34%. Agricultural self-sufficiency would however not change much for the ACI countries.
  4. Raising tariffs on agricultural imports to the legal limit by WTO would lower international food prices slightly as ACI and other developing countries trade less agricultural products as compared with the core scenario. This would however increase ACI countries' agricultural self sufficiency.

POLICY IMPLICATIONS

- Food security is likely to be greatest when agricultural markets are open, not only regionally but also globally, as this would make the markets more stable and predictable and thereby encouraging investment in the industry, providing employment and reducing poverty.
- Governments should not view food security as only a production issue and focus on food self-sufficiency, but rather see it also as a consumption issue linked with the spending capability of the poor.
- Developing nations need not wait for a multilateral trade agreement to benefit from freer trade; an ASEAN+6 free trade agreement would generate two-fifths of the GDP of global free trade
- Freer food trade within Asia would reduce the price volatility, especially for rice
- Investments in agricultural R&D have expected payoffs and have been shown to reduce poverty.

WHY IT MATTERS

With increasing income, consumers change their consumption and demand more food which has higher production costs such as meat. The economic rise of China, India and the ASEAN countries puts much more pressure on the world economy than the rise of East Asia did, due to the immense population size of these countries. Changing consumption patterns of such a huge population has significant impact for food security.