Countdown to ASEAN Economic Community 2015

With the ASEAN region and its economies now of critical importance, companies operating in Asia must prepare themselves to harness ASEAN's new efficiencies in order to stay competitive.

By Chris Devonshire-Ellis

The term "ASEAN" is cropping up more and more often these days, yet many business executives in China are still unaware of what it is and why it is growing in importance. The answer is fairly simple – ASEAN is at the forefront of free trade in Asia.

That means reduced or zero customs duties across an area of Southeast Asia including ASEAN's ten member states of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam. Collectively, ASEAN represents a market of some 600 million people, with a combined GDP of about USD1.8tr. If it were a single country, ASEAN would be the ninth-largest in the world in economic terms, and it is effectively situated as a counterbalance to the emerging economies of China and India.

One impact of the ASEAN Economic Community will be that Vietnam will become an even more serious competitor to China for lower-end manufacturing

On China's radar

Recognising this potential, and eager to leverage its own growing wealth, China has specifically targeted the ASEAN bloc as a destination for Chinese investment. This makes sense: Chinese companies need to expand overseas, and right next-door they can find a hotbed of growth in sales and trade. Indeed, ASEAN overtook Japan last year to become China's third-largest trade partner, with trade figures reaching USD362.3bn – behind only those of the European Union (USD567.2bn) and the US (USD446.6bn).

Even so, aware that not everyone has fully recognised the significance of ASEAN, the Chinese government has been working to strenuously promote Chinese trade with Southeast Asia, as seen through the recent establishment of a China-ASEAN trade office. Notably, China already has double taxation and free trade agreements in place with ASEAN.

The ASEAN-China Free Trade Area (ACFTA), being an agreement between China and the ten member states of ASEAN, came into effect in 2010. Combined, the ACFTA is the largest free trade area by human population and third-largest by nominal GDP in the world. The related free trade agreement reduced tariffs on 7,881 product categories, or 90 per cent of imported goods, to zero.

This reduction has already taken effect between China and the six original ASEAN members: Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand. The remaining four countries – Cambodia, Laos, Myanmar and Vietnam – are due to follow suit in 2015. Of these, Vietnam is the most significant player to watch: it shares a border with China and currently boasts wage levels at 30 per cent of those found in Jiangsu or Zhejiang provinces.

In addition to this, the Vietnamese Government has signalled that it intends to reduce its corporate income tax rate to 20 per cent beginning later next year – a full 5 per cent lower than China's. The impact will be that Vietnam, once coming into "ASEAN Economic Community (AEC) compliance", will be a serious competitor to China for lower-end manufacturing. Furthermore, with 90 per cent of all Vietnamese goods suddenly able to be imported into China duty-free, it will be the "ASEAN price" and not the "China price" that will matter to sourcing companies, buyers and end-users alike.

New strategies

China-based manufacturing businesses will need to adapt. At Dezan Shira & Associates, we have noticed that China-based investors who have also set up in Vietnam have typically refrained from closing their China facilities altogether, but rather allowed them to evolve under the new conditions. The "China factory" is still needed to produce more complicated parts, which are not yet easily made in Vietnam, and is required to penetrate further into the China supply chain.

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But less complex component parts can just as easily be manufactured by a Vietnamese subsidiary, imported, and then added into China production. This means that China-based WFOEs, FICEs and JVs may need to start thinking about three things: the cost of production in Vietnam, setting up a facility in the country, and a change in their China business scope to allow for both assembly and distribution.

As for the question of its infrastructure, Vietnam will not come close to China's production capabilities anytime soon. But as a general rule of thumb, if the Vietnam facility can get production down to 70 per cent of what it is in China, then it makes economic sense to relocate production.

These questions are crucial for the long-term survival of any China-based manufacturing facility. In this changed environment, if you don't start looking for cheaper-sourced components from Vietnam or elsewhere in ASEAN soon, then your competitors will first.

By the end of next year, these firms will have their own supply chains in place, and many will have invested in their own subsidiaries as a result. The question that remains is purely this – are you ready for 2015? You will certainly know in 2016, when ASEAN prices begin to seriously erode the cost of producing in China. SBR

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