De-Risking, but where to? The Emerging ASEAN countries as an alternative to China

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At a glance

- There is no way around China. Due to their limited economic power and numerous structural challenges, the Emerging ASEAN countries do not present an alternative to China in the foreseeable future. Nevertheless, they offer **diversification potential** for German and European companies within the framework of their **China+1** strategies.

- The Emerging ASEAN countries, especially due to their young populations, low wage levels, and advantageous geographical location, have **potential as production locations** for European companies. However, problematic aspects include low educational levels, low productivity, weak regulatory frameworks, high trade barriers, and poor infrastructure quality.

- High population numbers and an emerging, consumer-oriented middle class also make the Emerging ASEAN countries **attractive as markets**. However, relatively low income levels and high trade barriers reduce the attractiveness for European companies.

- As the largest trading partner of the Emerging ASEAN countries, **China dominates the markets and supply chains in the region**. For European companies, there is a risk that shifting production capacity could lead to pseudo-diversification, where supply chains run outside China's borders, but essentially remain Chinese-dominated.

- The EU should conclude its remaining trade negotiations with Indonesia, Malaysia, the Philippines, and Thailand. This requires a more **pragmatic trade policy** that does not overload trade negotiations with unrelated demands.

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I. Introduction[1]

The German government, as part of its Strategy on China, aims for an economic de-risking from China. A key element of this endeavour is a stronger diversification of the German economy – both in terms of China's central role in international supply chains and the strong dependence of many German companies on the Chinese market. There is no longer any talk of decoupling in German and European discussions. Instead, the German government aims to "promote the diversification of our economic relations so that we will continue to participate in China's economic development while reducing our dependence in critical sectors." Because China continues to be "of great importance for many companies owing to its share of the global market, its dynamism and innovativeness […]."[2]

However, how such de-risking shall be successfully implemented remains largely unclear. It is clear to the German government that, in addition to improving economic conditions in Germany and Europe, it is also necessary to make "better use of the strong potential of other countries and regions."[3] But which countries and regions have such high potential? How and where should German and European companies diversify to? Are there any alternatives to China suitable for a broad diversification strategy of the German economy? Which production locations and markets could compensate for a reduction in economic activities in and with China?

These questions are not easy to answer, especially for Germany. Because Germany is economically intertwined with China like no other country in Europe. China is not only Germany's most important trading partner, but almost one-third of all trade between China and the EU is with Germany. This makes it clear that diversification away from China requires tremendous efforts – and economic partners with the necessary growth potential to even be considered a serious alternative for the German economy.

In search of suitable partners, both politics and business often turn their attention to the emerging economies of Southeast Asia. The dynamic growth and relatively large markets of the so-called Emerging ASEAN (Indonesia, Malaysia, Thailand, the Philippines, and Vietnam) offer a seemingly promising alternative to the large neighbour China. However, a look at the economic data shows that the diversification potential in terms of Southeast Asia's emerging markets is limited. By 2030 China's gross domestic product (GDP) is projected to grow more than the total volume of the economies of all ten member states of the ASEAN combined. In almost all economically relevant factors, from income per capita to human capital to infrastructure quality, the Emerging ASEAN countries lag China to some extent. And there is no sign of Southeast Asia catching up economically: the annual growth rates of the five Southeast Asian economies are only marginally higher than those of China.

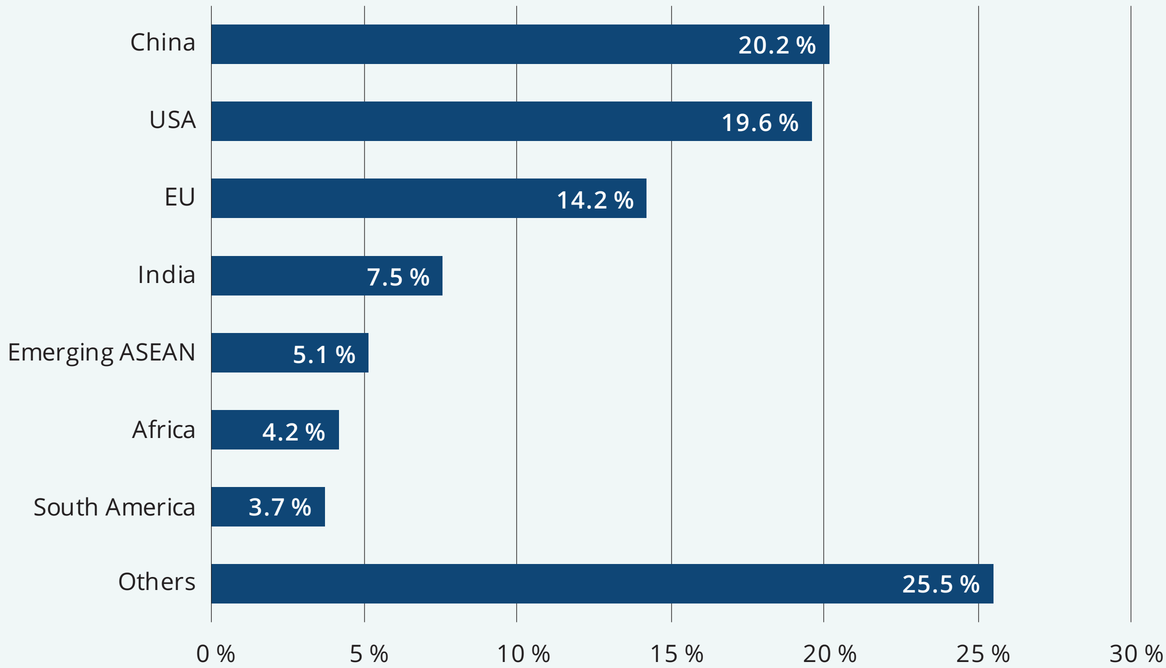
However, this does not mean that the Emerging ASEAN countries cannot be attractive for German and European companies. Especially for companies pursuing a China+1 strategy or seeking to establish a presence in Asia for the first time, the region offers considerable potential. This report aims to demonstrate, based on numerous comparative economic data, where the opportunities and limits of a diversification strategy of German companies in Southeast Asia lie. The result is clear: the Emerging ASEAN countries cannot replace China, but they can certainly complement it.

II. There is no way around China

China is now the world's second-largest economy and, even after decades of high growth rates, remains a powerhouse of the global economy. Even against the backdrop of a real estate crisis, deflationary tendencies, and the associated economic slowdown, current forecasts from the International Monetary Fund (IMF) show that the Chinese economy will contribute more than 20 percent to global economic growth over the next five years – more than any other economy in the world (see Figure 1). According to IMF calculations, by 2028, China will even have a larger GDP than the entire EU. The share of other emerging Asian players, such as India or the Emerging ASEAN, in global economic growth, however, remains significantly behind that of China. Emerging economies outside of Asia only play a subordinate role. Therefore, economically, there is no way around China in the coming years. This is particularly true for Germany and the EU with their economic model based on global trade and open markets.

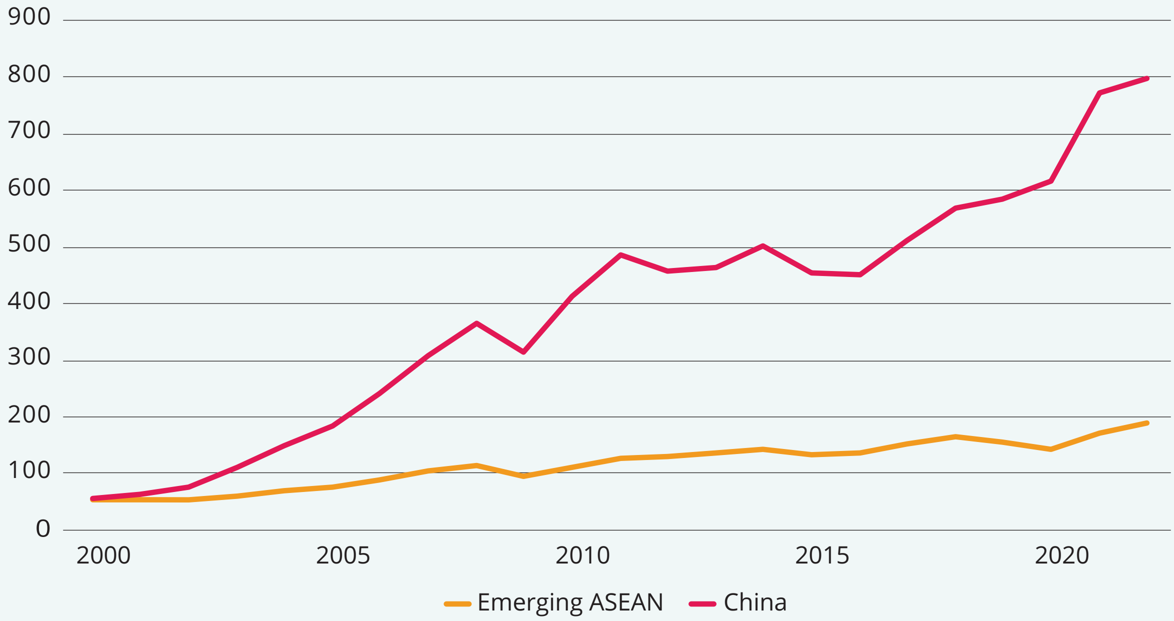
China is the EU's most important trading partner. In 2022, the total trade volume (imports and exports) between the EU and China amounted to more than 797 billion US dollars. The total volume of trade between the EU and China has grown almost fifteenfold over the past two decades. In contrast, the EU's trade with the Emerging ASEAN countries has not even quadrupled in the same period. While the EU's trade volume with China and the Emerging ASEAN was almost equal at around 55 billion US dollars in the year 2000, it now stands at just under 189 billion US dollars with the Emerging ASEAN (see Figure 2).

Figure 1: Estimated share of global GDP growth 2023–2028



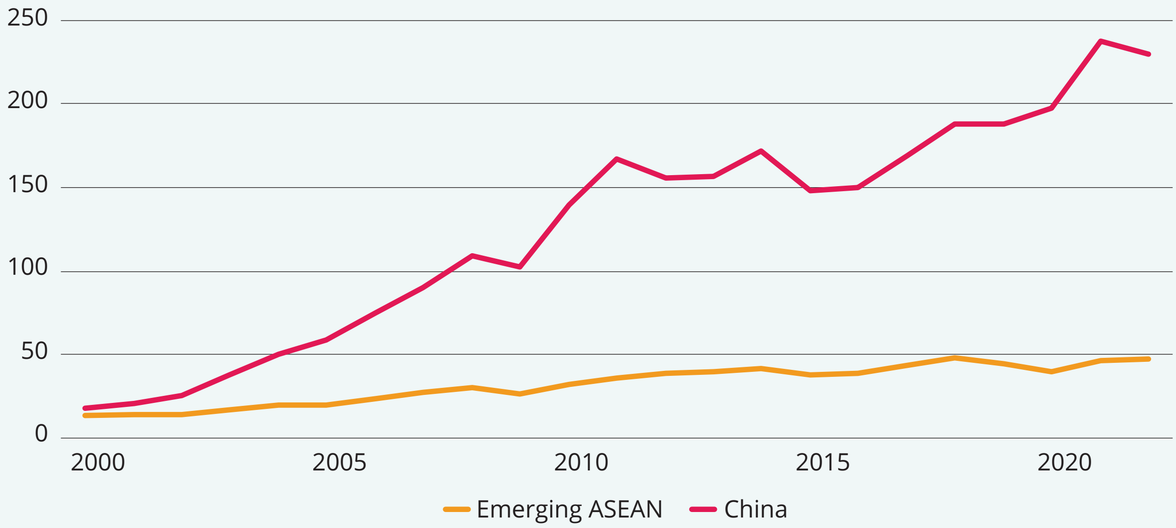
Source: author's own calculation based on IMF Datamapper, https://www.imf.org/external/datamapper

Figure 2: Trade volume of the EU in billion US dollars



Source: author's own calculation based on UN Comtrade Database, https://bit.ly/48KxlFL

Figure 3: Trade volume of Germany in billion US dollars



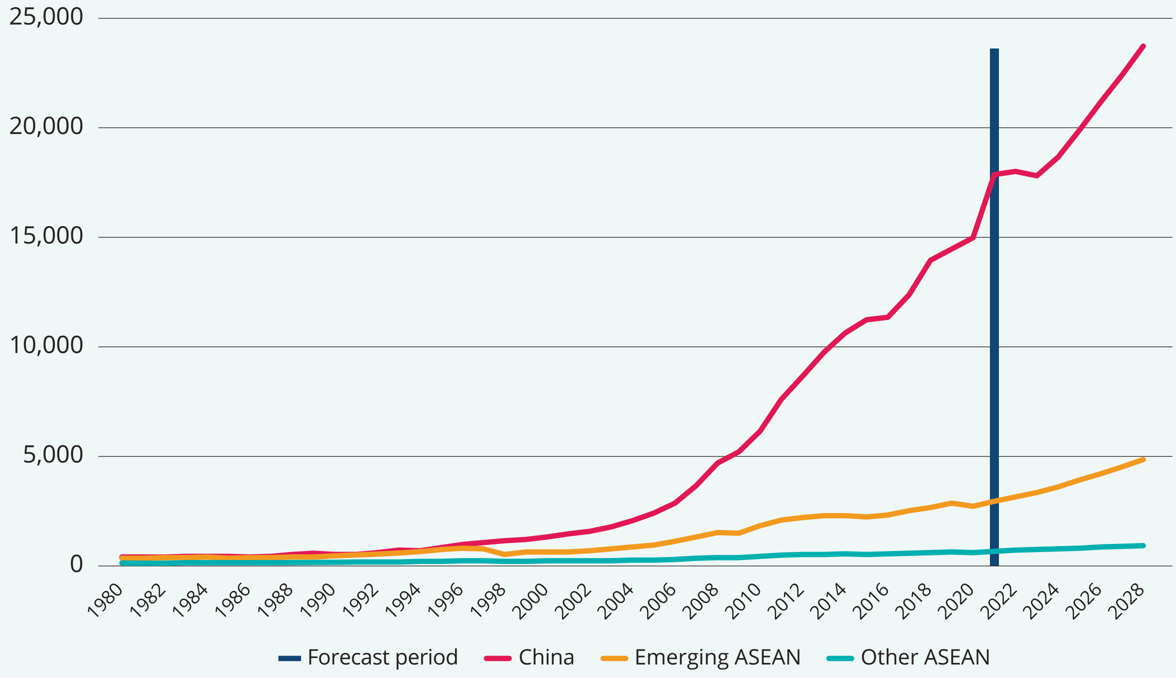
Source: author's own calculation based on UN Comtrade Database, https://bit.ly/48KxlFL

For Germany, the Chinese economy holds outstanding significance. Almost half of all European exports to China are attributed to German companies. Although the foreign trade volume between Germany and China in 2022 amounted to 229.5 billion US dollars, below the record value of 2021 (237.7 billion US dollars), it still exceeded the pre-pandemic level by more than 40 billion US dollars. In contrast, Germany's foreign trade volume with the Emerging ASEAN countries was only 47.8 billion US dollars in 2022, even slightly below the pre-pandemic level (see Figure 3).

For the Emerging ASEAN to be considered a real alternative to China for the EU in the coming years, they would need to embark on an economic catch-up race and demonstrate a significantly higher growth momentum than China. Only then could they contribute to a substantial shift of European trade flows away from China and into the region, potentially significantly reducing the enormous gap in trade volume between the EU and China. However, a glance at the growth forecasts for China and the five Emerging ASEAN countries provides little reason for such hope.

The IMF predicts a GDP growth rate of 4.2 percent for China in 2024, placing it roughly on par with Malaysia (4.3 percent) and well above Thailand's 3.2 percent economic growth. While the IMF forecasts a declining growth momentum for China by 2028, the same applies to the economic development of Malaysia and Thailand. For Indonesia, the IMF expects a consistent growth momentum of five percent annually over the next five years. Only for the Philippines and Vietnam, the two economies with the lowest per capita income among the Emerging ASEAN, does the IMF predict a more dynamic development with growth rates of well above six percent by 2028.[4] However, even such growth rates are too low for emerging and developing countries aiming to catch up with significantly more developed economies. South Korea, perhaps the most successful of the

Figure 4: Estimates of annual GDP 1980–2028 in billion US dollars



Source: IMF Datamapper, https://www.imf.org/external/datamapper

East Asian tiger economies, achieved double-digit growth rates in the 1980s. China's economy even grew at double-digit rates for decades from the 1980s well into the 2000s.

Regarding the overall economic performance, the comparatively moderate growth rates of the Emerging ASEAN mean that these states cannot narrow the large gap with China. On the contrary, China will even extend its lead in the coming years. By 2028, China's GDP is projected to increase from today's 17.7 trillion US dollars (in 2023) to 23.61 trillion US dollars, while the Emerging ASEAN will only increase from 3.23 trillion US dollars (in 2023) to 4.73 trillion US dollars (see Figure 4). This means that the Chinese economy will grow by more in the next five years than the entire projected economic output of the Emerging ASEAN in 2028 – in other words: China's economy will grow by a whole ASEAN until 2028.

China is the most important trading partner of Southeast Asia and the largest competitor of the EU in the region

In addition to the relatively moderate growth rates of the Emerging ASEAN, another factor complicates the diversification of German and European economic relations from China to the region. ASEAN, as one of the (despite all the aforementioned data) most dynamic economic regions in the world, also attracts other economic powers. Japan, South Korea, Australia, the USA, and many others are expanding their economic relations with the economies of Southeast Asia. However, the sharpest economic competitor for the EU in the region is China itself. Not only for the EU, but also for the countries of Southeast Asia, China has gained tremendous economic importance in recent years. China benefits from the ASEAN-China Free Trade Area (ACFTA) and from being a member alongside all ASEAN countries of the Regional Comprehensive Economic Partnership (RCEP), the largest free trade zone in the world – unlike the EU, whose trade negotiations with the Emerging ASEAN countries have significantly stalled since the successful conclusion of negotiations with Vietnam in 2019.

China has become by far the most important economic partner for the countries of the region. While the trade volume between the EU and the Emerging ASEAN has developed relatively slowly in recent years, the volume between China and the Emerging ASEAN has nearly doubled in the last five years (see Figure 5).

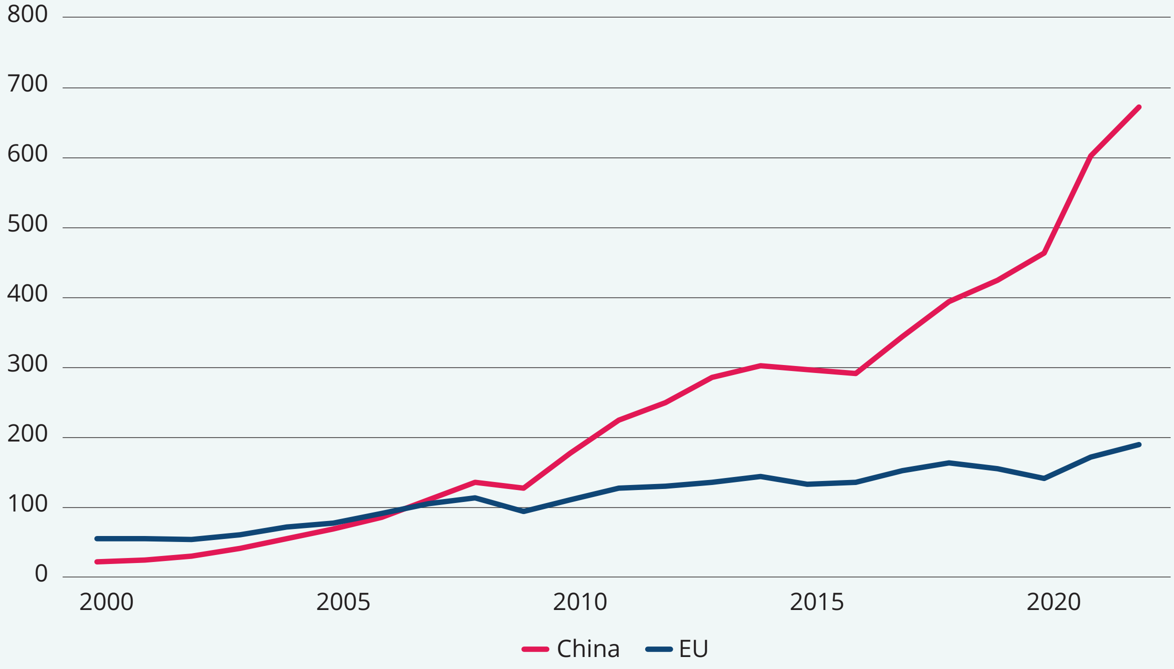
China is increasingly specialising in the production and export of sophisticated industrial goods, thus directly competing with German and European industrial companies.[5] The rising number of Chinese cars (especially with electric drive) on the streets of Southeast Asia, while German and European brands remain invisible, is just the most visible sign of the advance of Chinese industry in the region.

No diversification in sight

Despite all political speeches and heated public debates, diversification of the German economy away from China has not materialised so far. While German foreign trade with China declined significantly in 2023, this is mainly due to special effects in the chemical and automotive sectors.[6] Movements towards de-risking by German companies are only observed to a very limited extent.[7] For example, in a study conducted by consulting firm PWC, only one percent of the surveyed companies indicated that they intend to abandon their operations in China.[8] Other company surveys also show that a majority of German companies, which rely on inputs from China, do not plan to take measures to reduce their dependence on China or even intend to further expand their procurement and investments in China.[9]

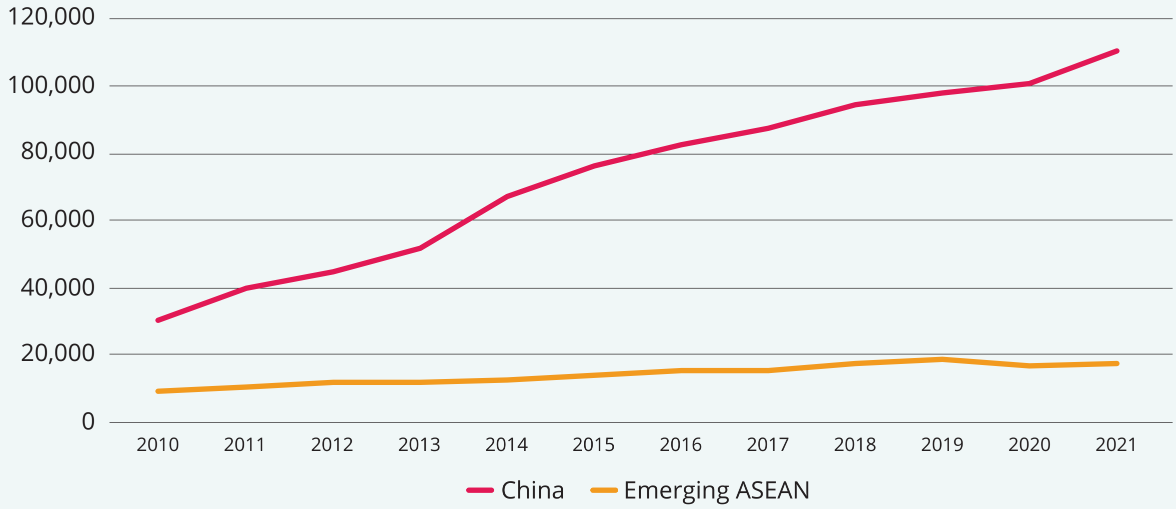
German direct investments in China have also increased massively in recent years. The stock of all German direct investments in China is currently about six times higher than the value in the Emerging ASEAN countries (see Figure 6). In fact, the stocks of German direct investments in the Emerging ASEAN have largely stagnated for several years. Only Thailand and Vietnam have experienced an increase in German direct investments in recent years – although in Vietnam, still at a

Figure 5: Trade volume of the Emerging ASEAN in billion US dollars



Source: author's own calculation based on UN Comtrade Database, https://bit.ly/48KxlFL

Figure 6: German direct investment stocks in million euros



Source: Deutsche Bundesbank Investment Statistics, https://www.bundesbank.de/resource/blob/804098/723ed10658859047d43037185ee49bb4/mL/ii-bestandsangaben-ueber-direktinvestitionen-data.pdf relatively low level.[10] In contrast, German direct investments in China reached a new record high in 2023, amounting to 11.9 billion euros.[11]

The reasons why German companies cannot or do not want to reduce their economic relations with China can be diverse and are still largely unexplored.[12] However, regarding economic data, it is clear that for many companies, China is currently irreplaceable both as a production location and as a huge market. Genuine alternatives to the Chinese economy are lacking. The hope that the emerging ASEAN countries can provide this alternative is misplaced – this is clearly shown by the growth, trade, and investment figures of the Emerging ASEAN compared to China.

Nevertheless, the countries of the region can play an important role for German and European companies, especially within the framework of China+1 strategies. The Emerging ASEAN are strategically located along some of the world's most important trade routes and in close proximity to major markets in the Asia-Pacific region such as Australia and Japan. Additionally, besides RCEP, the states are members of several other regional and bilateral free trade agreements. Therefore, these countries present themselves as regional production centres from where markets outside of China in the region could be served. Furthermore, with a population of around 596 million people (ASEAN total around 671 million)[13] and a growing, consumer-oriented middle class, the Emerging ASEAN themselves are becoming increasingly important as a market. However, a closer look at the economic data of the five countries examined shows that even a China+1 strategy focusing on the Emerging ASEAN presents a significant challenge for German and European companies.

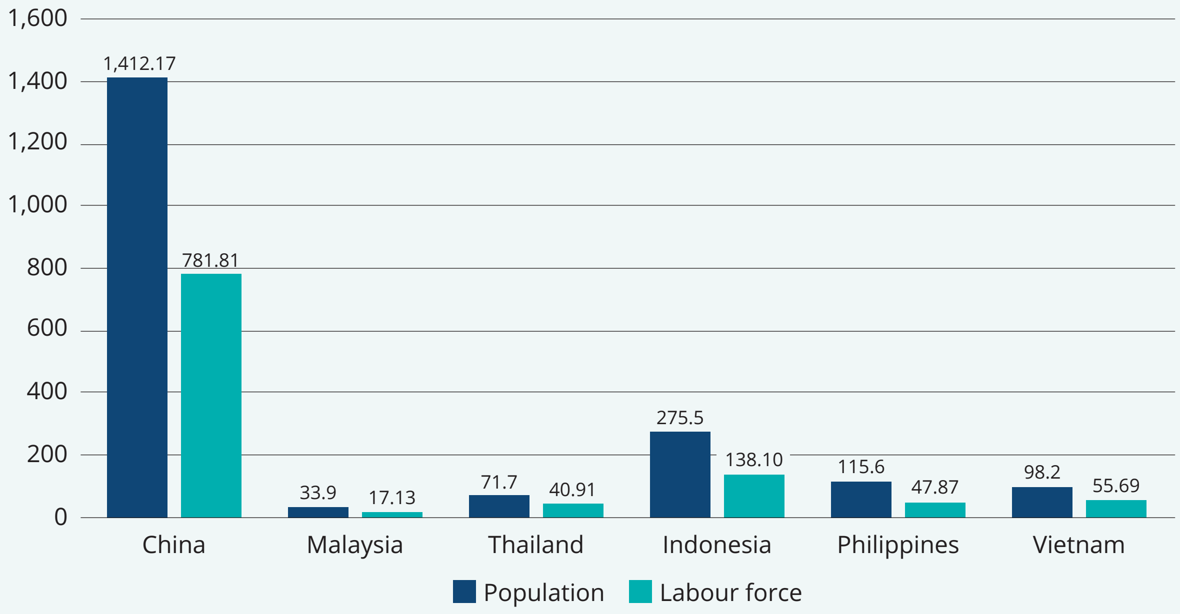
III. The potential of the Emerging ASEAN as a production location

At first glance, the potential of the Emerging ASEAN as a production location for German and European companies appears enormous. Even though the countries are significantly smaller than China, they have a large population and thus a huge labour pool. Four of the five Emerging ASEAN countries are among the top 20 most populous countries in the world. In Indonesia, for example, the fourth most populous country in the world with nearly 276 million inhabitants, the workforce comprises more than 138 million people (see Figure 7).

In terms of labour costs, the Emerging ASEAN also have a significant advantage in the location competition with China. The Chinese wages in manufacturing, at 1,130 US dollars, are significantly higher than those in the Southeast Asian emerging economies. Even in industrially relatively advanced Malaysia, industrial wages are nearly one-third lower than those in China. In Thailand, they amount to significantly less than half, and in Vietnam, not even one-third. In Indonesia and the Philippines, the wage level in manufacturing is even more than 75 percent lower than in China (see Figure 8).

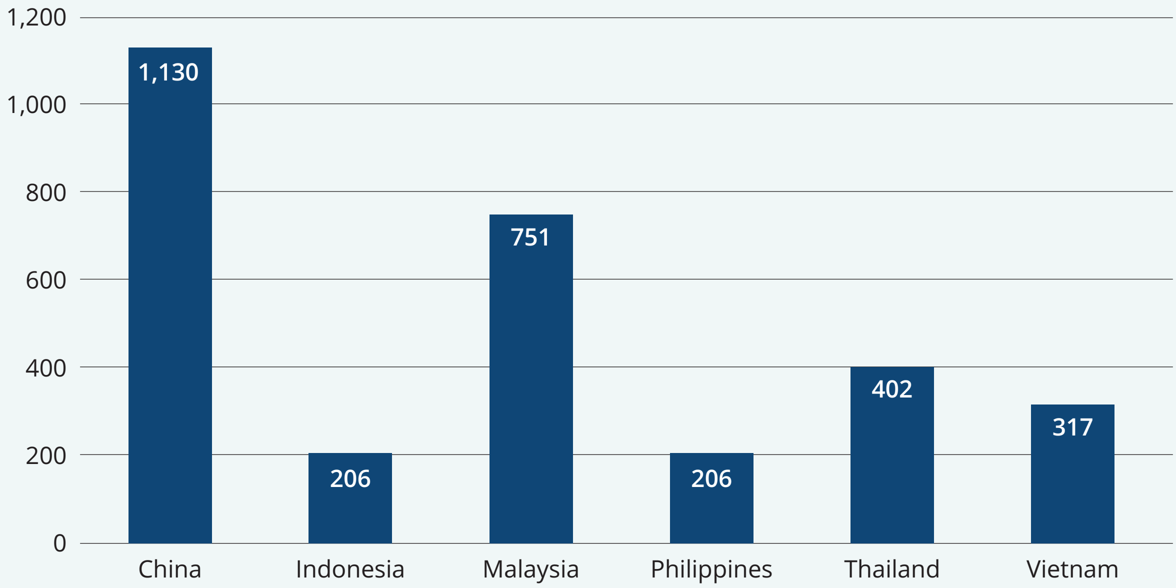
Moreover, the populations of the Emerging ASEAN, especially compared to China, Japan, and South Korea, are still relatively young. While the momentum of population growth has been steadily decreasing in the Southeast Asian emerging economies for two decades, these countries will not surpass their demographic peak for several years. Until then, the working-age population will significantly increase due to the high proportion

Figure 7: Total population and workforce 2022 in million people



Source: World Bank DataBank, https://databank.worldbank.org

Figure 8: Monthly manufacturing wages in US dollars* **



Source: Trading Economics, https://tradingeconomics.com/country-list/wages-in-manufacturing;
* The depicted data dates from Dec 22 (CHN), Jun 23 (VNM), Sep 23 (IDN, THA), Jan 24 (MYS); ** For the Philippines due to unavailability of data average total monthly wage level 2018 (ILOSTAT, https://ilostat.ilo.org/topics/labour-costs/) is used; nominal values in current US dollars.

of young people. For instance, 30 percent of the population in the Philippines are younger than 15 years old, 25 percent in Indonesia, 23 percent in Malaysia, and 22 percent in Vietnam. Currently, there is a low proportion of older people who are no longer in the workforce (see Table 1). An exception in the region is Thailand, which, like China, is already experiencing a decline in its population, which is significantly older compared to the other ASEAN countries.

Table 1: Population share by age 2022

	0–14 yo	65+ yo
China	17 %	14 %
Malaysia	23 %	8 %
Thailand	16 %	15 %
Indonesia	25 %	7 %
Philippines	30 %	5 %
Vietnam	22 %	9 %

Source: World Bank DataBank, https://databank.worldbank.org

Low levels of education and productivity

In the four younger countries of the Emerging ASEAN, much talk revolves around a demographic dividend. The large reservoir of young labour is expected to generate above-average growth rates and thus rapid gains in prosperity in the coming years. However, this hope for a demographic dividend is at risk of being disappointed, at least in Indonesia and the Philippines. This is because the many young people entering the job market lack the necessary level of education and training. In the current OECD PISA ranking, which compares the competencies of students in reading, mathematics, and science worldwide, the Philippines rank 77th (out of 81) with an average score of 353 points, well below the OECD average of 478 points. Indonesia also performs poorly, with an average score of 369 points and ranking 69th. Furthermore, the young generation in Indonesia suffers from a high youth unemployment rate of more than 22 percent.[14]

Table 2: PISA rankings 2022

Country	Ranking	Average points
Singapore	1	560
	...	
	...	
OECD average		478
	...	
Vietnam	34	468
	...	
Malaysia	55	404
	...	
Thailand	63	394
	...	
Indonesia	69	369
	...	
Philippines	77	353
	...	
	...	
Cambodia	81	337

Source: OECD's Programme for International Student Assessment (PISA) 2022, https://www.oecd.org/publication/pisa-2022-results/

Table 3: Human Capital Index (HCI) 2020

Country	Ranking	HCI value
Singapore	1	0.88
	...	
	...	
EU average		0.74
	...	
Vietnam	38	0.69
	...	
China	45	0.65
	...	
Malaysia	62	0.61
	...	
Thailand	63	0.61
	...	
Indonesia	96	0.54
	...	
Philippines	103	0.52
	...	
	...	
Niger	173	0.29

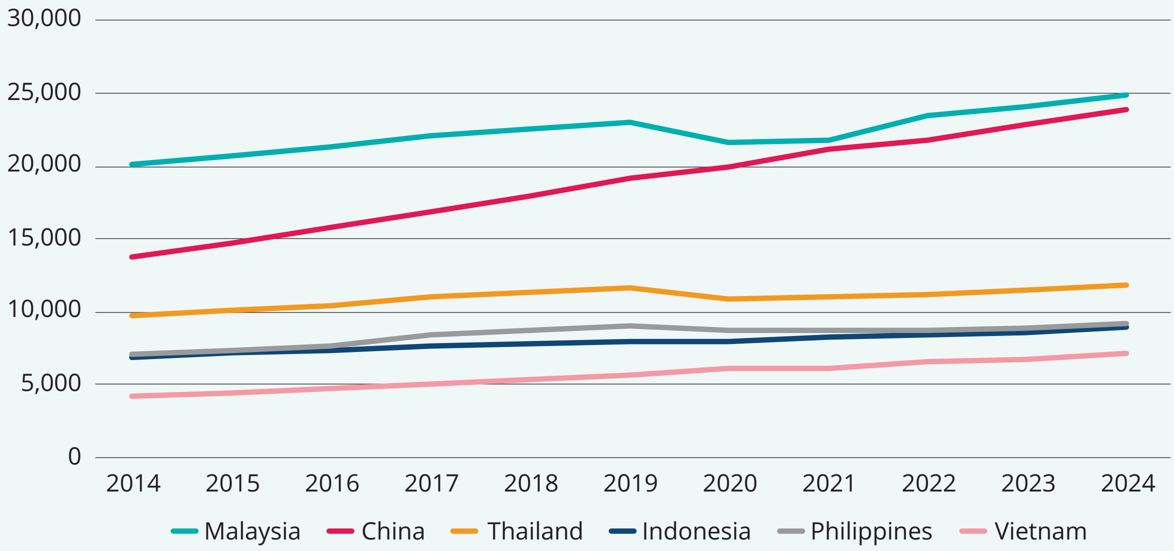
Source: World Bank, https://datacatalog.worldbank.org

The economically relatively developed Malaysia ranks in the midfield at 55th place but still significantly below the OECD average with 404 points. A positive outlier, however, is Vietnam. The country ranks just below the OECD average with 468 points, far ahead of its Southeast Asian neighbours (see Table 2). Considering Vietnam's still very low level of development and income, such a position in the PISA ranking is exceptional and demonstrates the progress the country has made in the education sector in recent years.

What the PISA results reveal for the young generation in the Emerging ASEAN can also be observed concerning the entire working-age population in these countries. The World Bank's Human Capital Index (HCI), which considers various parameters related to the education and health levels in a society, places the Philippines (ranked 103) and Indonesia (ranked 96) far behind. While Malaysia and Thailand are in the global midfield, they still lag behind China. Only Vietnam stands out in the ranking, ranked 38th, well ahead of China and not far from the average of EU countries (see Table 3).

Against the backdrop of relatively underdeveloped human capital in most Emerging ASEAN countries, it is not surprising that labour productivity is generally low in most of these nations. According to the International Labour Organization (ILO), Malaysia, due to its relatively high level of industrialisation, had a higher labour productivity than China in 2024, with 24,861 US dollars per employed person compared to China's 23,867 US dollars. The other Emerging ASEAN countries have significantly lower productivity figures. Thailand, within this group, has the highest value at 11,834 US dollars per year per worker, although productivity growth has been weak in recent years. In the Philippines, labour productivity has mostly stagnated in recent years and is expected to reach 9,196 US dollars in 2024, surpassing

Figure 9: Annual output per worker in US dollars



Source: International Labour Organization (ILO), ILOSTAT, https://ilostat.ilo.org/; nominal values in constant US dollars 2015

pre-pandemic levels for the first time. Indonesia's labour productivity has grown more dynamically in recent years but remains relatively low at 8,949 US dollars. Vietnam exhibits the most dynamic productivity growth; however, despite its strong performance in the aforementioned rankings, it ranks last among the Emerging ASEAN with 7,152 US dollars. This is because a large portion of Viet-nam's workforce is employed in labour-intensive and less productive sectors due to the country's low level of economic development.

Low competitiveness and challenging framework conditions

In addition to having a sufficient pool of well-educated and productive workers, German and European companies, when considering a location decision in favour of the Emerging ASEAN, rely on a competitive industrial sector as well as suitable legal and infrastructural frameworks. However, especially regarding the competitiveness of the industry, the considerable gap between China and the Southeast Asian emerging economies becomes apparent. The Competitive Industrial Performance Index (CIP) of the United Nations Industrial Development Organization (UNIDO) ranks China's industrial competitiveness at 0.37, globally second only to Germany, the country with the (still) highest industrial competitiveness. The Emerging ASEAN countries lag far behind or are

Table 4: Competitive Industrial Performance Index (CIP) 2021

Country	CIP rank	CIP score
Germany	1	0.40
...		
China	2	0.37
...		
...		
Malaysia	20	0.15
...		
Thailand	25	0.12
...		
Vietnam	30	0.11
...		
Indonesia	39	0.08
...		
Philippines	44	0.06

Source: UNIDO, https://stat.unido.org/database/CIP

Table 5: Institutional Quality Index (selected categories)

	China	Indonesia	Thailand	Philippines	Vietnam	Malaysia	Germany
Government Effectiveness	0.50	0.44	0.13	0.06	0.18	0.99	1.29
Control of Corruption	0.02	-0.43	-0.45	-0.54	-0.29	0.25	1.82
Political Stability and Absence of Violence	-0.44	-0.44	-0.38	-0.71	-0.03	0.14	0.62
Regulatory Quality	-0.42	0.21	0.17	0.06	-0.43	0.64	1.52
Rule of Law	-0.04	-0.19	0.07	-0.52	-0.16	0.56	1.53

Source: Worldwide Governance Indicators | World Bank DataBank, https://databank.worldbank.org/source/worldwide-governance-indicators, last updated 2023

significantly trailing (see Table 4). Malaysia, as the most industrially developed economy among the Emerging ASEAN, ranks 20th in the rankings with a score of 0.15, followed by Thailand at 25th with 0.12. However, both countries have lost industrial competitiveness in recent years according to the CIP. In contrast, Vietnam, with a score of 0.11, ranks 30th and has significantly gained in industrial competitiveness over the past two decades, rising nearly 50 places in the ranking since 2002. Bringing up the rear within the Emerging ASEAN in this index are Indonesia (0.08, ranking 39) and the Philippines (0.06, ranking 44). While industrial competitiveness in Indonesia has stagnated for years, it has even decreased in the Philippines despite the already low level. Overall, the industrial competitiveness of the Emerging ASEAN suffers from relatively low integration into global industrial supply chains as well as relatively low industrial value-added and productivity. For example, industrial value-added per capita in the Philippines is only about one-fifth of the corresponding value in China. Furthermore, less than one-third of the value of all industrial exports from Malaysia, for instance, can be attributed to domestic value-added. Additionally, in the case of Indonesia, it is noteworthy that only 30 percent of all industrial exports consist of medium and high-tech industrial goods – less than half of the corresponding share in the other economies of the Emerging ASEAN.[15]

Regarding the political and legal framework for foreign companies and investors, a mixed picture emerges among the Emerging ASEAN countries. A closer look at Malaysia clearly illustrates why the country, alongside Singapore, is economically by far the most developed economy in Southeast Asia. In relevant rankings, Malaysia leads significantly ahead of the other emerging economies in the region, as well as China. For example, in the Institutional Quality Index from 2023, Malaysia outperforms China and the other Emerging ASEAN countries in all categories. Although democratic Indonesia can still present relatively good scores in categories like Government Effectiveness and Regulatory Quality compared to China and the rest of the Emerging ASEAN, the overall picture for the Emerging ASEAN (excluding Malaysia) is very weak (see Table 5).

This is particularly due to a weak rule of law and the significant extent of corruption in the Emerging ASEAN countries compared to the rest of the world. While Malaysia performs relatively well in Transparency International's Corruption Perceptions Index with a score of 50 and a rank of 57, which is significantly better than the global average (score of 43), China (rank 76, score 42) and Vietnam (rank 83, score 41) still achieve scores only slightly below. However, in Thailand (rank 108, score 35) and especially in Indonesia and the Philippines (both rank 115, score 34), corruption is

Table 6: Corruption Perceptions Index 2023

Country	Global rank	Score
Denmark	1	90
...		
...		
Malaysia	57	50
...		
Global average		43
...		
China	76	42
...		
Vietnam	83	41
...		
Thailand	108	35
...		
Indonesia	115	34
...		
Philippines	115	34

Source: Transparency International, https://www.transparency.org/en/cpi/2023

Table 7: International Trade Barrier Index (TBI) 2023

Country	Global rank	TBI score
Singapore	1	2.57
...		
...		
Malaysia	45	3.88
...		
Vietnam	77	4.75
...		
China	78	4.8
...		
Philippines	81	5.15
...		
Thailand	85	5.42
...		
Indonesia	86	5.47

Source: Tholos Foundation, https://www.tradebarrierindex.org/

more widespread compared to global standards (see Table 6).

Central to assessing the diversification potential of the Emerging ASEAN countries are the conditions for cross-border trade in these nations. Uncomplicated rules for importing intermediate goods and exporting finished products are crucial if German and European companies are to relocate their production to the region. The International Trade Barrier Index (TBI) by the Tholos Foundation, which annually compares the 88 largest economies in the world in terms of the extent of their trade barriers, also paints a mixed picture here. In the TBI ranking, Malaysia stands out with a score of 3.88 and ranks 45th, well ahead of the other Emerging ASEAN countries. Vietnam, with a score of 4.75 points and ranked 77th, is roughly on par with China at 78th place.

The Philippines, and especially Thailand and Indonesia, rank towards the bottom of the rankings due to relatively high trade barriers (see Table 7). Despite a high level of protectionism for foreign investors, China remains unavoidable due to its economic size and its significant role in global trade. However, this is not the case for the significantly smaller and economically weaker economies of the Emerging ASEAN. Their extensive trade barriers risk deterring European companies looking for potential production locations in the region.

In addition to favourable legal frameworks, companies consider the quality of existing infrastructure in the countries under consideration when making location decisions. Areas such as transportation and logistics are particularly important. Factories rely on well-developed logistics infrastructure and transport routes in order to be able to reliably and efficiently source intermediate goods for their production and transport their finished products to customers both domestically and internationally. The World Bank's Logistics Performance Index (LPI), which compares 139 countries worldwide, takes into account not only traditional transport infrastructure such as roads and railways but also indicators such as the quality of cus-

Table 8: Logistics Performance Index (LPI) 2023

Country	Rank	LPI score
China	19	3.7
Malaysia	24	3.6
EU average		3.6
Thailand	26	3.5
Philippines	43	3.3
Vietnam	43	3.3
Indonesia	61	3

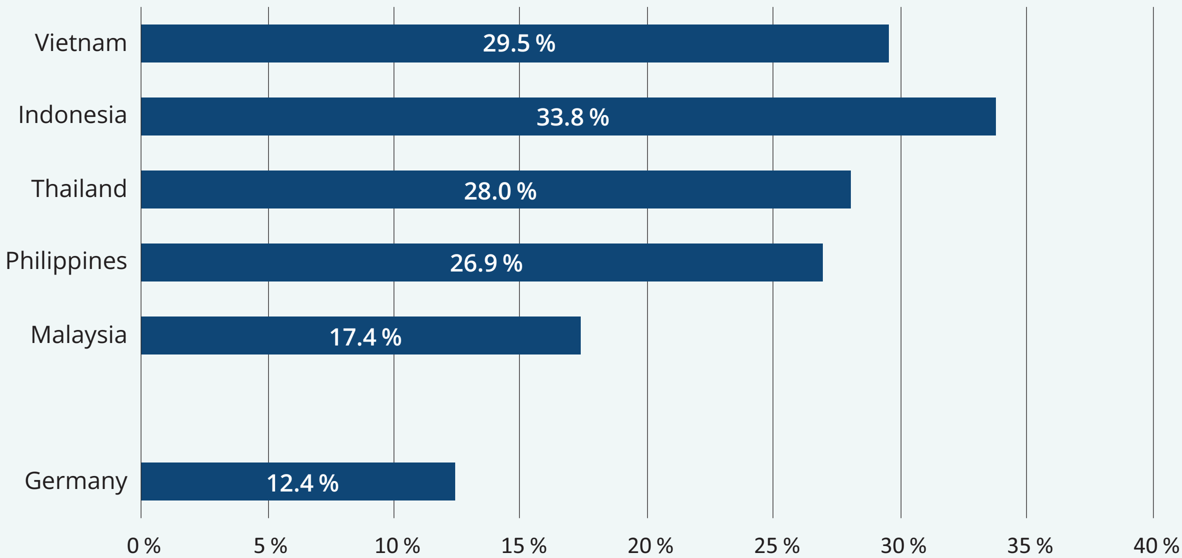
Source: World Bank, https://lpi.worldbank.org/international/global, lowest score = 1, highest score = 5

toms clearance and international shipments. High quality in these areas is essential for efficient integration into global supply chains as a production location. Therefore, it is not surprising that the top positions in the LPI ranking are occupied by the most highly integrated economies in world trade, such as Singapore, Germany, the Netherlands, Japan, South Korea, the United States, or China. Malaysia and Thailand also perform relatively well, ranking 24th and 26th, respectively. However, the Philippines, Vietnam, and especially Indonesia lag behind in the ranking, with rankings of 43rd and 61st, respectively. This is due not only to the relatively low quality of the overall transport infrastructure but also to weak scores in customs clearance and international shipment.

China is already dominating supply chains in the Emerging ASEAN

The question of whether relocating production from China to the Emerging ASEAN or establishing an additional production site as part of a China+1 strategy makes sense depends not only on the economic, legal, and infrastructural location factors. An important criterion is whether establishing a production site in the Emerging ASEAN would actually lead to diversification in the sense of a China+1, or whether, due to the close interconnections of the Southeast Asian economies

Figure 10: Share of intermediate goods imports from China as a share of total intermediate goods imports 2021



Source: World Integrated Trade Solutions (WITS) 2024, https://wits.worldbank.org/

with China, the diversification effect for German and European companies would be low or practically non-existent. A closer look at the share of imports of intermediate goods from China out of all imported intermediate goods in the Emerging ASEAN is sobering.

China dominates the industrial supply chains in the Emerging ASEAN with an enormously high share of all intermediate goods imports (see Figure 10). More than one-third of all imported intermediate goods in Indonesia originate from China. In Vietnam, the share is 29.5 percent, in Thailand 28 percent, in the Philippines 26.9 percent, and even in Malaysia, it stands at a significant 17.4 percent. In comparison, the share of Chinese intermediate goods imports in Germany, which is particularly criticised for its high dependence on China in terms of industrial integration, is only 12.4 percent. For Vietnam, the British newspaper *The Economist* recently calculated an almost 100 percent correlation between the monthly increase in imports from China and in exports to the USA. This suggests that the increasing relocation of production from China to Vietnam, especially concerning the USA, primarily aims to circumvent the high tariffs imposed on Chinese imports in recent years.[16] Whether a similar correlation exists concerning Vietnam's growing trade balance with the EU is unclear. However, the fact that Vietnam, as the first and so far the only country in the Emerging ASEAN, concluded a free trade agreement with the EU in 2019 and thus enjoys preferential access to the European market, at least makes such an assumption does not seem unfounded. The high share of Chinese intermediate goods imports in the Emerging ASEAN makes it clear that establishing a production site in the region would only partially reduce dependence on China. German and European companies might still rely on a high proportion of Chinese intermediate goods in their factories in Southeast Asia. In such a case, a China+1 strategy would ultimately be little more than pseudo-diversification – diversification in terms of geography but not in terms of supply and value chains.

IV. The potential of the Emerging ASEAN as a market for European products

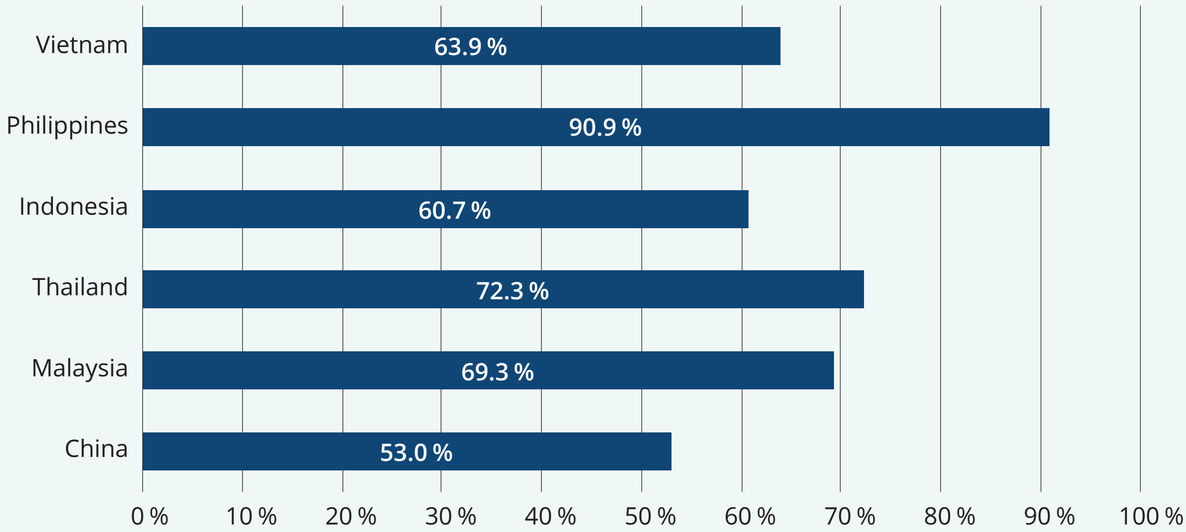
Despite its recent economic slowdown, China remains one of the world's most important markets for the German and European economy. With a total volume of 97.3 billion euros in 2023, China was Germany's fourth-largest export destination behind the United States, France, and the Netherlands.[17] For the EU as a whole China is the third-largest export market with a volume of 223.5 billion euros, following the USA and the United Kingdom.[18] However, these export figures do not take into account the goods that German and European companies produce in China for the Chinese market. In fact, the export figures are likely to significantly underestimate the importance of the Chinese market for the German and European economies. After all, numerous large German and European companies, especially in manufacturing, generate between ten and 15 percent of their global profits in China.[19] However, for many European companies, the market environment in China is becoming increasingly challenging. The Chinese government aims to make itself technologically more independent from abroad with its "Made in China 2025" strategy and actively supports the competitiveness of Chinese companies in numerous key industries.[20] For German and European companies, this means facing growing domestic competition in the Chinese market. This has already been felt in sectors such as mechanical engineering or the automotive industry, where German companies have recently lost market share to Chinese companies.[21]

Diversification is therefore not only a question of risk reduction for European companies regarding the Chinese market, but also an economically necessary strategy to tap into alternative markets with growth potential for their products in the long term. The economies of the Emerging ASEAN countries offer enormous potential in this regard at first glance. With a total population of around 596 million people and a rapidly growing middle class, the five countries have a significant reservoir of potential consumers. Indeed, private consumption is one of the key drivers of growth in the Emerging ASEAN. In comparison to China, for example, both state and private consumption expenditures in these countries account for a significantly larger share of the total gross domestic product. While in China consumer spending accounts for only 53 percent of the gross domestic product, in the Emerging ASEAN countries it is mostly well above 60 percent, and in the Philippines, it is even more than 90 percent (see Figure 11).

Moreover, the relatively dynamic economic growth in the Emerging ASEAN, coupled with the increasing interest of many international industrial companies in the region as a regional production hub, is leading to a rising demand for industrial goods and intermediate products. This presents new opportunities, particularly for German and European companies in sectors such as mechanical engineering or the supplier industry.

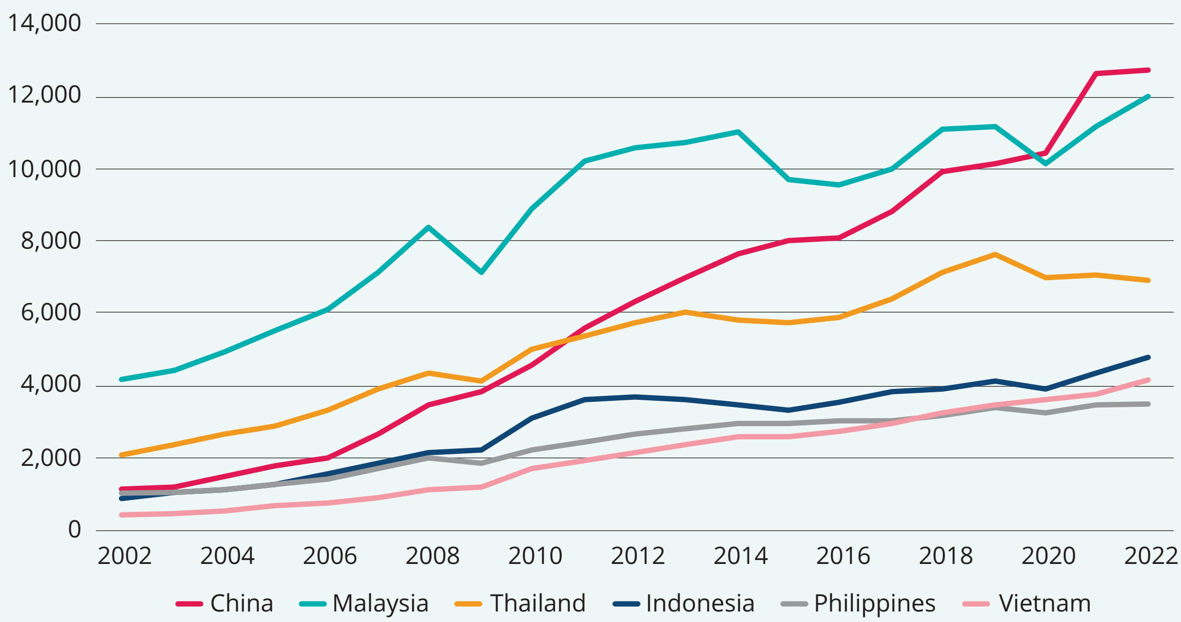
However, a closer analysis tempers overly high hopes regarding the potential of the Emerging ASEAN as alternative markets for the German and European economy. Some factors that were discussed previously regarding the potential of these five countries as production locations also pose significant challenges in terms of market diversification. Lengthy and complicated customs procedures, as well as inadequate port capacities, for example, hinder the import of goods. Additionally, protectionist rules – both high tariffs and numerous non-tariff trade barriers – in countries like Indonesia and the Philippines make access to these potentially huge markets expensive or, in some cases, nearly impossible. Here, a significant disadvantage for European companies is evident due to the lack of free trade agreements. Countries such as Australia, Japan, South Korea,

Figure 11: Consumption spending as a share of GDP (2022)



Source: World Bank DataBank, https://data.worldbank.org/

Figure 12: Annual income per capita in US dollars



Source: World Bank DataBank, https://data.worldbank.org/; nominal values in current US dollars or India threaten to outpace Europeans thanks to free trade agreements and regional trade zones like RCEP or CPTPP. This is especially true for China, which, within a few years through ACFTA and RCEP, became the largest source of imports for ASEAN. Between 2017 and 2022 alone, Chinese imports into ASEAN grew by 70 percent. China is responsible for almost 25 percent of all imports into the region. 80 percent of imports from China are industrial goods – primarily electronics, machinery and machine parts, and chemical products.[22] These are products with which Chinese manufacturers directly compete with German and European industrial companies on the global market and in the Emerging ASEAN.

To keep up with Chinese competition, European companies urgently need better access to the markets of the Emerging ASEAN. Therefore, they depend on the swift conclusion of the still-open trade negotiations between the EU and Malaysia, Thailand, Indonesia, and the Philippines. However, even if many tariffs and non-tariff trade barriers for European imports into these countries were to be eliminated in a timely manner, it is questionable whether German and European industrial companies could prevail against Chinese competition in the markets of the Emerging ASEAN. China worldwide relies on low prices as the most important competitive advantage for its products – this applies to both consumer goods and high-tech industrial products. This particularly affects German and European companies that offer their high-quality consumer and industrial products at relatively high prices on the world markets. The significance of this competitive advantage in the markets of the Emerging ASEAN is evident when looking at the per capita income in the five states.

Within the Emerging ASEAN, only Malaysia has an annual per capita income of 11,993 US dollars, which is roughly comparable to China's 12,720 US dollars. Even in Thailand, the per capita income is only 6,910 US dollars and has decreased since 2018. In Indonesia and Vietnam, although the per capita income has increased rapidly in recent years, it remains relatively low at 4,788 US dollars and 4,164 US dollars respectively. The Philippines lag even further behind. With 3,499 US dollars, the per capita income is now even lower than Vietnam's (see Figure 12). Moreover, the income level declined during the pandemic and has recovered only slightly compared to pre-pandemic levels.

This makes it clear that the market potential for German and European products in the Emerging ASEAN, except for relatively small Malaysia, is limited. This is most evident in the example of the automobile market. While German automakers sold around 4.4 million cars in China in 2022[23], they sold less than 10,000 vehicles in the largest Southeast Asian automotive market, Indonesia, in the same year. This corresponds to a market share of less than one percent.[24] The Indonesian automotive market is dominated by affordable Japanese, Korean, and increasingly Chinese models, which are often assembled in Indonesia with imported components. Such models would hardly convince quality-oriented German car buyers with strong purchasing power, but in the growing Indonesian middle class, which can often fulfill the dream of owning a car for the first time due to the low prices, these vehicles are very popular. In the growth markets of Southeast Asia, price often outweighs quality – a further competitive disadvantage for the German and European economy.

V. Conclusion and policy recommendations

For the European and especially the German economy, there is currently no way around China. The second-largest economy in the world is too important as a production location and trading partner. At the same time, a stronger diversification is imperative for European companies regarding China. On the one hand, it is essential to reduce the significant dependencies on China, especially in critical areas. On the other hand, Chinese companies, under the "Made in China 2025" strategy of the Chinese government, are increasingly becoming competitors to Europeans in their own market. Therefore, China+1 will become a strategic necessity for many European companies in the future.

Despite the limited potential of the Emerging ASEAN, the Southeast Asian emerging economies can and must play a central role in the China+1 strategies of German and European companies. Due to the most dynamic growth rates globally and a growing, young, and increasingly (albeit moderately) affluent population, the Emerging ASEAN offer promising conditions for diversification of production and markets away from China, despite all limitations.

Malaysia

Malaysia stands out as the best performer across all categories in the regional comparison, usually with a significant lead. Malaysia's economy is well developed, with a technologically advanced industry, a relatively well-educated and productive workforce, and solid conditions for foreign companies and investors. Malaysia is also an attractive market due to its relatively high income level. Although the country has a population of only 34 million, it likely has the most potential for diversification efforts by primarily high-tech European companies in the short term.

Vietnam

However, in the long term, **Vietnam** could become the country with the greatest diversification potential. Although Vietnam currently ranks at the bottom in most categories compared to other Emerging ASEAN countries, it has significantly improved in almost all areas in recent years. A significant advantage for Vietnam is its cheap yet well-educated workforce, coupled with rapidly improving industrial competitiveness. Moreover, Vietnam's 2019 free trade agreement with the EU makes it particularly attractive to European companies compared to its Southeast Asian neighbours without such agreements.

Thailand

Although **Thailand** still performs relatively well in the regional comparison with other Emerging ASEAN countries in most categories, a closer look at the data suggests that the Thai economy is increasingly living off its substance. Economic growth is too low, at around three percent, for a developing country, and key economic indicators such as productivity and income stagnate at a low level. Moreover, Thailand's population is already ageing and shrinking. This raise concerns that Thailand may become a "grows old before it gets rich" country.

Indonesia and the Philippines

Indonesia and the **Philippines** boast dynamic economic growth and a large workforce reservoir, which, although relatively poorly educated and therefore less productive, is also very cost-effective compared to regional peers. Additionally, Indonesia, with more than 275 million people and a rapidly growing middle class due to rising incomes, offers a huge market, making it attractive as a regional production hub for foreign companies. Furthermore, Indonesia is one of the largest producers of commodities such as nickel, cobalt, and copper, which are crucial in the context of the global energy and mobility transition. However, both countries have relatively challenging regulatory environments. Especially high levels of legal uncertainty and corruption could deter foreign investors. Moreover, in the Philippines and particularly in Indonesia, a significant amount of protectionist rules and measures, such as high tariffs, non-tariff trade barriers, or complex import regulations and procedures, add further difficulties in accessing these potentially vast markets.

The biggest uncertainty factor regarding the diversification strategies of German and European companies away from China and towards Southeast Asia likely is the Chinese influence in the region. China is now the most important trading partner of the Emerging ASEAN and dominates the region's supply chains. Thus, in the case of relocating from China to ASEAN, there is a risk of merely a pseudo-diversification, where a predominantly Chinese-dominated value chain simply shifts outside Chinese borders. A similar trend is already observable in Vietnam due to its direct proximity to China.

The high economic dependence of the region on China also poses enormous challenges for the Emerging ASEAN themselves. On the one hand, China already uses its economic influence in the region to exert political pressure on individual countries. On the other hand, due to their close integration with the Chinese economy, the Southeast Asian emerging economies are excessively affected by the current economic downturn in China.[25] Thus, the Emerging ASEAN also have an interest in diversifying their own economic and trade relations. For Germany and the EU, this is an opportunity they should seize.

The EU should adopt a more pragmatic trade policy towards ASEAN

For European companies to truly exploit the diversification potential in the Emerging ASEAN, the EU must finally conclude its trade negotiations in the region. While the EU signed a free trade agreement with Vietnam in 2019, negotiations with Indonesia, Malaysia, Thailand, and the Philippines, some of which have been ongoing for years, have made little progress. The main obstacle to a successful conclusion of negotiations is the EU's efforts to impose non-trade demands, such as extensive labour and environmental standards, within the negotiations. Countries like Indonesia reject this approach and accuse the EU of protectionism under the guise of climate protection and human rights. With the region's growing economic interest worldwide and already stagnant trade with the EU, the Emerging ASEAN countries are increasingly able and willing to walk away from trade negotiations with the EU.[26] For the EU, this would be a significant setback, both in terms of European diversification efforts and the already declining geopolitical influence of Europe in the region. The EU needs the ASEAN states to achieve its ambitious goals, such as regarding global climate protection, the reform of multilateral trade rules, or the protection of free trade routes. Failure of its trade negotiations would further fuel the region's dependence on China.

The EU should no longer overload trade negotiations with non-trade demands and instead decouple such issues, where they are not directly trade-related, from trade policy issues. The EU has many other instruments to support social development or climate protection in the Emerging ASEAN countries. The most important instrument is undoubtedly the Global Gateway Initiative, within which the EU plans to invest ten billion euros in green transformation and sustainable connectivity in ASEAN countries over the next few years.[27] Here, too, European companies could benefit from the swift conclusion of open trade negotiations. And concerning Global Gateway, the EU should not burden potential investment projects in ASEAN countries with excessive conditions, either. Because China, with its own Belt and Road Initiative, is ready to partner with Southeast Asia for investments, while acting much more pragmatically.

It is also essential for the European Commission and the German government to provide even stronger support to European companies in their diversification efforts in Southeast Asia. The introduction of special conditions by the German government in October 2023 for taking over investment guarantees in countries with high diversification potential was a step in the right direction. It is essential that the various instruments of foreign trade promotion are not overloaded with requirements regarding non-economic objectives. This would not only unnecessarily complicate and delay companies' diversification efforts but also mean a competitive disadvantage compared to non-European competition not subject to such requirements.

Moreover, political support for the engagement of European companies in the Emerging ASEAN should be expanded. The relatively low number of high-ranking political visits from the EU to the ASEAN countries can be significantly improved. As with similar visits to China or India, high-level political delegations from Germany and Europe in the region should be accompanied by high-level business delegations from representatives of German and European companies.

The Emerging ASEAN countries are brimming with confidence given their dynamic economic development and the increasing global interest in the region. From the EU, the ASEAN countries expect a genuinely equal and partnership-based policy. Indonesian President Joko Widodo made this stance clear in his highly anticipated speech at the EU-ASEAN Summit 2022 in Brussels: "If we want to build a good partnership, the partnership must be based on equality, no coercion. There should not be any dictating parties who believe that their standard is better than others."[28] For the Emerging ASEAN, Europe is now just one option among many, and patience with an EU perceived as morally arrogant is wearing thin in the region's capitals. Therefore, the EU should adopt a more pragmatic policy towards Southeast Asian emerging countries. With a raised finger and insisting on European standards, Europe will not be successful in ASEAN. On the contrary, as states like China and the USA, but also Australia, Japan, South Korea, or India, are queuing up with the Emerging ASEAN, Europe increasingly risks being left behind.

1 The author likes to thank Prof. Marcus Marktanner of Kennesaw State University, USA, for his extensive support in data research and preparation, as well as for numerous valuable comments and insights during the creation of the study.

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