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Emerging Markets in Asia Need to Adapt Their Growth Model in a Post-COVID World

By David Skilling

Key Points

- Asian emerging markets have prospered with an economic model that was heavily leveraged to a particular model of globalisation, notably through integration into global supply chains of manufactured goods.
- This export-led model is now under significant pressure as globalisation continues to change. These dynamics have been strengthening for some time as the capital intensity and sophistication of production increases. This reduces the importance of low wage and cost structures and suggests that human capital and specialist supply chains are more important.
- Covid-19 will accelerate this process, with an accelerated transition to digital technologies and automation – and growing pressure in some advanced economies to bring production home. Some economies will struggle to adjust to these new competitive realities. More developed Asian economies are more likely to be able to successfully transition than less developed emerging markets.
- New economic strategies will be required in many Asian emerging markets in response. First, upgrading of existing sectoral strengths is required to respond to new competitive realities, together with the development of new growth engines. Second, a sharper focus on regional markets, catering to the preferences of the Asian consuming class. And third, improving productivity in the domestic economy in addition to an export-led model.

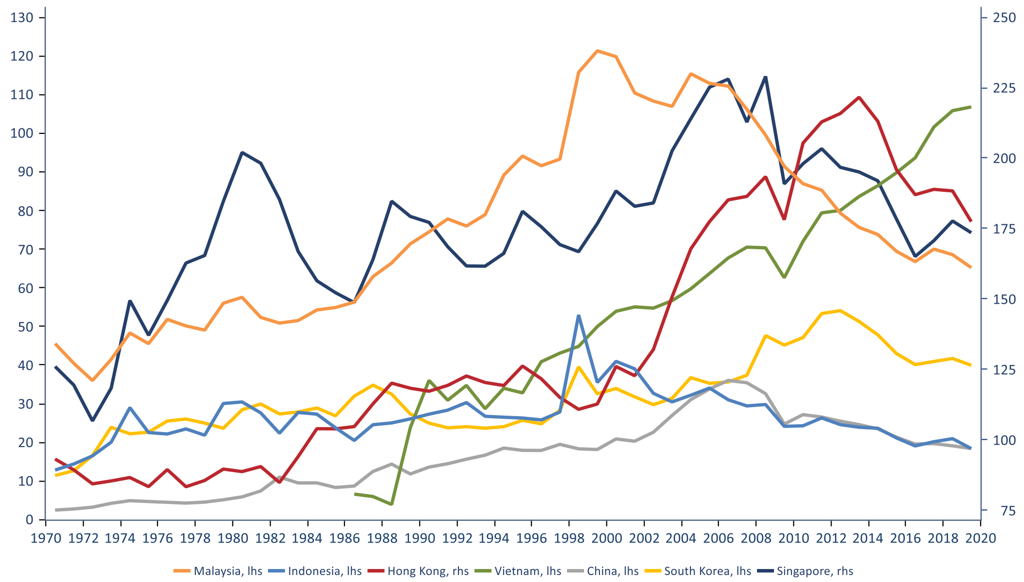
Issue

From the east Asian dragons in the 1960-1980s to the ASEAN tigers in the 1990s and more recent development stories such as Vietnam, export-led growth has been central to economic success across Asian economies. The specifics vary, but their ability to converge towards the global income frontier has been based on significant growth in exports – in many cases supported by substantial inward FDI and integration into global supply chains.

However, this model seems to be weakening for some emerging Asian economies. Note the difficulties that more recently developing Asian economies have in creating employment rich manufacturing sectors ('premature deindustrialisation'); as well as the 'middle income trap' where Asian economies have struggled to kick on to higher income status.

Indeed, as shown in Figure 1, the growth in the export shares in several Asian economies (e.g. Malaysia, Indonesia, South Korea) has notably flattened or weakened over the past two decades.

Figure 1: Exports/GDP, selected Asian countries, 1970 – 2019



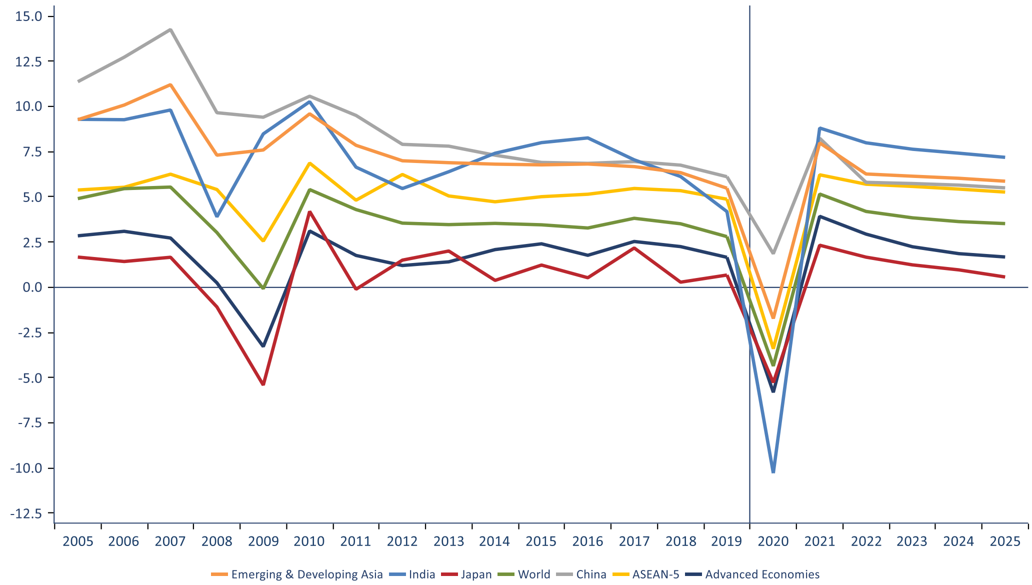
This is partly because globalisation (in terms of growth in trade and foreign direct investment) has been slowing over the past decade. But as importantly, it is because globalisation is changing in nature.

Emerging markets in Asia have benefited from a particular type of globalisation with far-flung supply chains. But globalisation is becoming more regional, with more localised supply chains as new production technologies and business models emerge. Regional economic and political integration in Asia and Europe has also supported more regional trade and investment flows.

Covid-19 will reinforce these existing dynamics, creating new challenges for the existing export-oriented economic models of many emerging market economies in Asia. Around the world, the shift to digital and to a greater reliance on automation and technology in production was markedly accelerated in 2020. This will also apply to services-based export economies, like India and the Philippines, as technologies such as artificial intelligence (AI) take hold. And there are commercial and political pressures for relocation of global supply chains, as firms and governments focus on strengthening resilience.

These post-Covid dynamics will be felt acutely in Asia. Although the IMF and others forecast Asia to lead the global economic recovery over the next several years (Figure 2), partly because of its strong performance in containing Covid-19, there will be structural headwinds as growth models are challenged.

Figure 2: Real GDP growth, 2005 – 2025 (f), IMF



Assessment

In aggregate, there is a risk that convergence by Asian emerging markets will weaken; and that advanced economies will be better positioned for this new environment than emerging markets. The growth trajectory for Asian emerging markets may be less healthy than it was for previous generations of Asian emerging markets.

But as importantly, there will be substantial variation across Asian emerging markets in terms of their exposure to these dynamics. The economies that are best placed to adapt to these dynamics are those with stronger human capital, innovation capability, access to specialist supply chains and services, strong infrastructure and business environment conditions, and so on.

One implication is that there will likely be a broader distribution of outcomes across Asian emerging markets. More developed countries, with stronger domestic capabilities, are better placed.

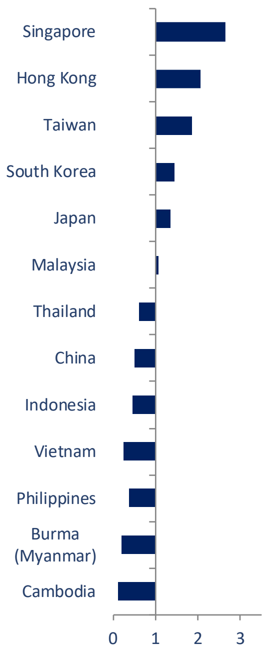
Economies like Taiwan and South Korea, with world-class strengths in technology, are poised to do well. And economies like Vietnam, which combine strong human capital and increasing capabilities around manufacturing with a relatively low wage structure, are also well-positioned – and indeed, are attracting significant amounts of FDI (including from companies relocating from China).

However, Asian economies that are less developed, are engaged in less sophisticated activities (such as textiles and basic manufacturing), and where the cost structure is an important part of the value proposition are likely to face growing challenges. This may compromise the ability of lower income Asian economies to converge towards the regional average.

There may also be challenges for Asian economies with higher cost structures that are not fully aligned with the skills and capabilities required to transition to more capital and technology intensive production processes. Economies like Malaysia and Thailand may be examples here.

In short, relatively labour-intensive economies are likely to be disadvantaged in a post-Covid world relative to the more productive capital and knowledge-intensive economies. Economies at the top of the labour productivity rankings (Singapore, Taiwan) are likely to be better positioned to transition than less productive economies such as Cambodia and Myanmar (Figure 3).

Figure 3: Labour productivity per worker (indexed to average)



Export-led activities will continue to be central to the economic models of Asian emerging markets – for the most part, their domestic markets are not sufficiently large to drive the productivity growth that is needed for prosperity.

Recommendations

Economies around the world are facing structural challenges to their growth models in a post-Covid world and are grappling with how best to adapt. Even as GDP growth in emerging Asia recovers after the Covid shock, governments (and firms) will need to adapt their growth models to new economic realities in a post-Covid world.

This will be unlike the response to the global financial crisis in which globalisation continued after a sharp recession, albeit at a slower pace than before. This time, the economic shock will have enduring structural impacts on economic behaviour and performance. Governments need to develop a clear assessment of their exposure to changing dynamics.

There are three related clusters of policy recommendations for governments: a change in sectoral focus; a change in market focus; and focus on domestic productivity.

First, there is a need to upgrade aggressively to remain competitive in external markets, given changing firm behaviour. Emerging Asia will need to accelerate the journey to increasingly sophisticated forms of manufacturing and related services: this will involve investments in skills, innovation capability, infrastructure, and so on. And the footprint in these areas of competitive advantage will need to expand given the likely lower levels of labour intensity in more sophisticated production. New growth engines will be needed, in both manufacturing and services. The options for upgrading will not be possible for all countries to the same extent, but progress needs to be made. Emerging Asian markets cannot continue with the same model.

Second, Asian emerging markets must rotate their external focus from global supply chains towards other Asian markets. As globalisation becomes more regional in nature, with some firms retreating from far flung global supply chains, there may be greater opportunities in directly serving Asian consumers and firms. A greater Asian focus may also be more feasible for emerging Asian markets, reducing the extent of the immediate upgrading challenge.

An Asian integration agenda should be a strategic priority to diversify exposures (although high concentration in markets like China should be avoided). Initiatives such as the recently concluded Regional Comprehensive Economic Partnership (RCEP) are valuable in this regard; although it is 'thin' relative to more ambitious deals like the Trans-Pacific Partnership, it can still be valuable for the participating Asian economies. And the substantial differences in level of development across Asia means that there are substantial gains from trade.

There is an increasing amount of regional and global investment capital flowing into firms that are serving Asian consumers, in activities from fintech to online retail and mobility, indicating that there is substantial economic value in this space.

Third, Asian emerging markets must improve productivity in the domestic economy. Although domestic sectors do not offer the same potential for productivity improvement as export-led growth for most Asian economies, it will become increasingly important as working age population growth is reduced in many Asian economies – and as challenges increase in external sectors.
Governments need to continue with overdue policy reforms: upgrading the business environment, improving capital markets and banking activities, investing in science and technology, and upgrading their infrastructure. Particularly in larger Asian markets, such as Indonesia and India, this can also be an important source of future growth.

Overall, policymakers need to develop a clear view on the changing regional and global environment – and respond aggressively and creatively. A new development policy agenda is needed.

Dr David Skilling is the founding Director of Landfall Strategy Group, an economic and policy advisory firm that works with governments, firms and financial institutions in Asia, the Middle East, and Europe, with a specific focus on small advanced economies. David has previously worked in various roles in the New Zealand Government, founded an independent economic think tank in New Zealand, and was with the McKinsey Global Institute and McKinsey & Co in Singapore.

David holds a Ph.D. in Public Policy, and a Master in Public Policy degree, from Harvard University, as well as a Master of Commerce degree in Economics from the University of Auckland. David was named as a Young Global Leader by the World Economic Forum in 2008.

HKUST IEMS
INSTITUTE FOR EMERGING MARKET STUDIES

T: (852) 3469 2215
E: iems@ust.hk
W: http://iems.ust.hk
A: Lo Ka Chung Building, The Hong Kong University of Science and Technology, Clear Water Bay, Kowloon

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