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Exit Strategies for ASEAN Member States: Keeping Production Networks Alive Despite the Impending Demand Shock*

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Key Messages:

- **Although the coronavirus disease (COVID-19) started by causing both supply and demand shocks,** the demand shock will be dominant in the exit from the emergency. A deep and long recession is expected throughout the world.
- **Our production system is mostly intact – ready to restart –** but a long-lasting demand shock could hurt it. Another challenge is the prolonged restriction on the movement of people, particularly across borders. Keeping production networks alive and strengthening international competitiveness are challenges for the ASEAN Member States (AMS).
- **Mandatory social distancing is changing our economy, society, and daily lives.** It is also accelerating the penetration of digital technologies. AMS must keep up with this structural change and utilise it for economic development.
- **Health and economic polices may be coordinated in the framework** of (i) emergency responses, (ii) exit policies, and (iii) policies for the new normal.

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Some Association of Southeast Asian Nations (ASEAN) Member States (AMS) are still fully engaged in emergency responses to the coronavirus disease (COVID-19). Human life is of the utmost importance and must be prioritised over other issues. It is crucial to keep the pandemic curve within the capacity of healthcare systems – even if the immediate pain from social distancing is huge. ERIA hopes that all AMS and countries in the rest of the world overcome this difficult challenge soon.

At this point, we must start considering the next stage. This policy brief will talk about the exit strategies for AMS after successfully taming the spread of the disease.

A Demand Shock, not a Supply Shock

Economists have said that COVID-19 has generated both a supply shock and a demand shock (e.g. Baldwin, 2020). This was accurate in March 2020 but will not be so from now on, particularly for AMS.

The AMS initially perceived COVID-19 as the source of a supply shock in January and February, creating a shortage of certain intermediate products originating in China. Then the disease spread in March and a substantial share of production activities was stopped across the world. Why did we stop production? To implement our health policy, i.e. social distancing, which halts both supply and demand. What will happen after the disease is brought largely under control? We would be happy to resume production if demand returned. Our production facilities and networks are still there – almost intact. After taming the disease, we must fight the demand shock. Low demand will hurt supply if it persists in the long term.

* Our recent policy brief (ERIA, 2020) asserted the importance of connectivity, trade liberalisation and facilitation, and investment liberalisation and facilitation. This policy brief intends to place this assertion in a broader policy space for the recovery from the ongoing COVID-19 crisis.

Emergency supplies, such as personal protective and medical equipment, should be treated separately from other goods. Emergency supplies are in short supply and their prices are rising, so long international supply chains may be considered high risk. On the other hand, there is no shortage of supply for most other products, and prices are stable; it is hoped there will be no shortage of food and some basic needs. What we must worry about is how to keep production capacity alive while having social distancing and the ensuing negative demand shock.

The trough of global economic performance is likely to be very deep and prolonged – causing a recession that will generate a serious demand shock which may decay the whole economy. We must expect to see a lot of bankruptcies, massive unemployment, possibly worsened performance in the financial sector, and, hopefully not, a collapse in asset and foreign exchange markets. At that point, macroeconomic stimulus will be crucial, and we must pay attention to how our production networks could survive.

Globalisation not Passé

Don't blame globalisation. Although the movement of people has spread the disease, we will surely want to travel again when the disease is under control – perhaps 2–3 years from now – with some travel replaced by digital connectivity. We should not go back to a dark age of immobility. With a proper set of healthcare and economic policies, we can thrive in a globalising world.

In the next few years, however, we must go along with some restrictions on the movement of people, particularly across borders. The speed at which people resume domestic and international mobility may differ across countries, which will complicate the process of getting back to normal. Some industries, such as transportation and tourism, will be particularly affected by the travel restrictions. The movement of people is also important for international production networks (IPNs). Maintaining value chains with minimal movement of people will surely be a challenge, but we must get through this difficult period by setting up tighter communications through the internet and other media.

Resilience and Complexity of IPNs

AMS, together with surrounding East Asia, have led the world in taking advantage of IPNs for sustained and inclusive economic growth. The fragmentation theory states that an improvement in location advantages and a reduction in service link costs are required to attract production blocks in IPNs (Jones and Kierzkowski, 1990). In addition, the formation of efficient industrial agglomeration is crucial for stabilising the industrial structure, allowing local firms to participate in production networks, and encouraging technology transfer and spillover (Kimura and Ando, 2005; Kimura et al., 2010; ERIA, 2015). AMS have made efforts to meet these requirements, both at the country and regional levels. Initiatives for the ASEAN Economic Community and the Master Plan on ASEAN Connectivity have worked well to accelerate these efforts.

We use 'international production networks' here, which differs from 'global value chains' (GVCs). While GVCs include all sorts of international industrial linkages, IPNs (e.g. in the machinery industries) are based on the task-wise international division of labour, connected by tight service links. This corresponds to the second unbundling, in contrast to the first unbundling (Baldwin, 2016). IPNs are a subset of GVCs, and only a small number of countries – including AMS – have participated in them.

IPNs are known to be resilient against short-term supply or demand shocks because of such characteristics (Obashi 2010; Ando and Kimura, 2012; Okubo, Kimura, and Teshima, 2014). Networks may become a transmission mechanism in the spread of a shock, and negative responses to the shock can be stronger than in other parts of the economy. However, once the shock is over, production and trade can return faster and stronger along networks than in other types of activities. That is because the core of production networks consists of relation-specific transactions, and such complexity is built up only with substantial long-term investment.

This is good news. Possible bad news is that once networks are lost during a prolonged recession with a lot of uncertainty, they are difficult to resume because of their complexity. To keep production networks alive, it is important to shorten the duration of low demand to a minimum, while upgrading location advantages and reducing service link costs.

Acceleration of Digital Economy

COVID-19 will be around for a while. We must live with it, perhaps for 2 or 3 years. This will certainly change our economies, societies, and lifestyles. The world will not go back to exactly the same 'normal'; the 'new normal' will emerge. The penetration of digital technologies will accelerate and AMS can take advantage of this immense change.

From the viewpoint of industrial development, countries could adopt three different strategies to move forward. The first is to utilise information and communication technology to enhance international competitiveness in IPNs by upgrading location advantages and reducing service link costs. We call this a 'step-by-step' strategy. The second is to encourage the introduction of information and communication technology in traditional industries such as agriculture, fisheries, cottage industries, transportation, tourism, and others, which is called the 'feedback' strategy. The third is to promote new digital-related businesses – the 'leap frogging' strategy.

Table 1 : Policy Framework for Overcoming COVID-19 by ASEAN Member States

Item	Emergency responses	Exit policies	Policies for the new normal
Health policy	• Conduct social distancing • Provide testing • Keep medical treatments within capacity	• Carefully remove social distancing • Set medical services back to normal • Develop international collaboration to exit (medical supply, vaccines, quarantine)	• Establish long-term healthcare system • Disseminate health insurance • Develop international cooperation for pandemic prevention
Macroeconomic policy	• Stabilise exchange rates and avoid a collapse of asset markets • Provide mitigation to help businesses and people at risk	• Provide macroeconomic stimulus (monetary, fiscal) • Develop international macro policy coordination	• Resume fiscal health and accelerate inclusion to improve resilience • Develop macro policy coordination framework
Policies for IPNs	• Keep IPNs and related industries alive with human distancing	• Keep IPNs and related industries alive with worldwide recession and some restriction on people's movement • Strengthen location advantages and reduce service link costs (connectivity, trade and investment liberalisation/facilitation)	• Better position in IPNs with competitive location advantages (human capital, infrastructure, institutions) and reduced service link costs • Make ASEAN a competitive region to attract innovative production networks
Policies for a digital economy	• Remove bottlenecks for teleworking and other digital connectivity	• Utilise ICT to strengthen international competitiveness in IPNs • Apply ICT in traditional industries • Encourage digital-related businesses • Promote e-government • Establish domestic and international policy discipline for the free flow of data and data-related businesses	• Effectively utilise ICT for development • Develop innovation hubs to promote the application of ICT • Establish a secure policy environment for the free flow of data • Further develop the ASEAN Digital Integration Framework, E-commerce Agreement, and other initiatives
Economic situation	• Forced halting of economic activities for social distancing	• Prolonged recession in the world • Slow recovery of the cross-border movement of people	• The new normal • More efficient/thick value-added production networks • More penetration of digital technology

ASEAN = Association of Southeast Asian Nations; COVID-19 = coronavirus disease; IPN = international production network; ICT = information and communication technology.
Source: Author.

Policy Framework for AMS

The table presents a tentative layout of the policies necessary for the AMS to emerge from the turmoil of COVID-19. Health and economic policies consist of (i) emergency responses, (ii) exit policies, and (iii) policies for the new normal. The period for the exit policies may be more prolonged than we originally expected, so some elements of the policies for the new normal may need to overlap with the exit policies.

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