

COVID-19 and Southeast and East Asian Economic Integration: Understanding the Consequences for the Future

Economic Research Institute for ASEAN and East Asia*

Key Messages:

- **The coronavirus disease (COVID-19) pandemic poses great challenges** for the economic integration of East and Southeast Asia. Much of the future of the integration depends on measures and coordination amongst countries in the region.
- **ASEAN is the natural leader in the recovery** from the pandemic, by deepening economic cooperation amongst countries under the EAS framework. The ASEAN Community (Economic and Socio-Cultural) is a natural platform, as the need to cooperate with East Asian countries (Dialogue Partners) is embedded in the community blueprints.
- **This policy brief presents directions** that ASEAN could take in the context of the recovery and for strengthening economic regionalism to withstand similar shocks in the future.
- **It is important for ASEAN to have sustained connectivity** within East and Southeast Asia to maintain the competitiveness of regional production networks. There is also an urgent need for workable mechanisms to facilitate public-private partnerships, as many countries are still in recovery mode after huge stimulus packages during the pandemic.
- **ASEAN will further liberalise the trade and investment regime** to maintain the competitiveness of GVCs in the region. Trade liberalisation is focused on NTMs and the service sector, with the objective of minimising restrictions from NTMs and providing sufficient services to support GVCs within domestic economies.
- **Opening up the investment regime at the ASEAN initiatives is important** to maintain the attractiveness of the AMS as the location of MNEs and foreign investment in general. Inviting policy should be put in place to ensure that foreign direct investment stays in the region and to accommodate MNEs in balancing their investment portfolios in the post-pandemic era.
- **Connectivity enhancement and trade-and-investment liberalisation as described above are important policies** to improve the attractiveness of the ASEAN region as an investment destination. The current disruption in GVCs raises concerns about reshoring by MNEs that so far have invested in the region. Therefore, ASEAN needs to embark on policy actions to mitigate such concerns, by further opening up investment regimes and by encouraging MNEs to balance their investment portfolios.
- **Strengthening initiatives in several areas is warranted** under the ASEAN Socio-Cultural Community to prepare AMS for similar events in the future. One area that could be reinforced is social protection and insurance schemes, which are increasingly integrated into the broader natural disaster response under the ASEAN Socio-Cultural Community.

* This policy brief is a joint work between members of the Research and Policy Design Department of the Economic Research Institute for ASEAN and East Asia (ERIA), under the guidance of ERIA's President, Chief Economist, and Chief Operating Officer. Lead and corresponding author: Senior Economist Dr Dionisius Narjoko (dion.narjoko@eria.org)

The coronavirus disease (COVID-19) pandemic has severely affected East and Southeast Asian economies, especially by disrupting the flow of goods and services in the region's global value chains (GVCs). Since a similar pandemic is likely to happen in the future, we must learn from the experience, make efforts to build new economic and social systems, and invent new methods of doing business, economic governance, and regulation to keep adverse pandemic impacts to a minimum. It is, therefore, important for the Association of Southeast Asian Nations (ASEAN) Member States (AMS) and Dialogue Partners to strengthen economic integration by sustaining seamless connectivity and opening up the trade and investment regime. The adoption of the technology of the Fourth Industrial Revolution (IR 4.0) – such as artificial intelligence, IoT, automation, and robotics – gives manufacturing firms a better chance of rapidly increasing production when the economy recovers.

ASEAN has successfully innovated its systems, with high responsiveness and resilience to change in these fast-moving times. As a resilient and responsive region, it can become the natural leader to demonstrate the optimum economic and social systems for undertaking all the adjustments needed to sustain economic integration in Southeast and East Asia, while offering an example for the global community. This policy brief presents the direction that AMS, together with their Dialogue Partners, can take to overcome the aftermath of COVID-19.

A New Coronavirus Disease, Known as COVID-19, Caught the World by Surprise

Originating in an outbreak in Wuhan, China in early January 2020, COVID-19 quickly spread to other cities across the world in less than 3 months. The number of infected people soared from just under 50 cases in mid-January to 1.5 million cases by the second week of April. The epicentre of the disease has shifted to multiple countries, and the outbreak was finally labelled a global pandemic by the World Health Organization in mid-March. Public health systems around the world are struggling to contain the extremely contagious disease, leading to a series of lockdowns and severe restrictions on public activities lasting several weeks.

The pandemic has had serious economic consequences. Stock markets around the world have plummeted to their lowest levels in a decade and exchange rates have fluctuated wildly, reflecting the extremely high uncertainty caused by the pandemic. Globally, central banks have been engaged in a race to the bottom with interest rates, and fiscal authorities have developed generous fiscal packages in a bid to sustain demand and minimise adverse impacts on growth.

One reason for the uncertainty is that there is no clear picture of how the disease will transform the global economy, which is characterised by production networks and interdependence, or whether it will alter the way the economy is run. This policy brief attempts to shed some light on these questions in relation to the future of regional integration between East and Southeast Asian countries.

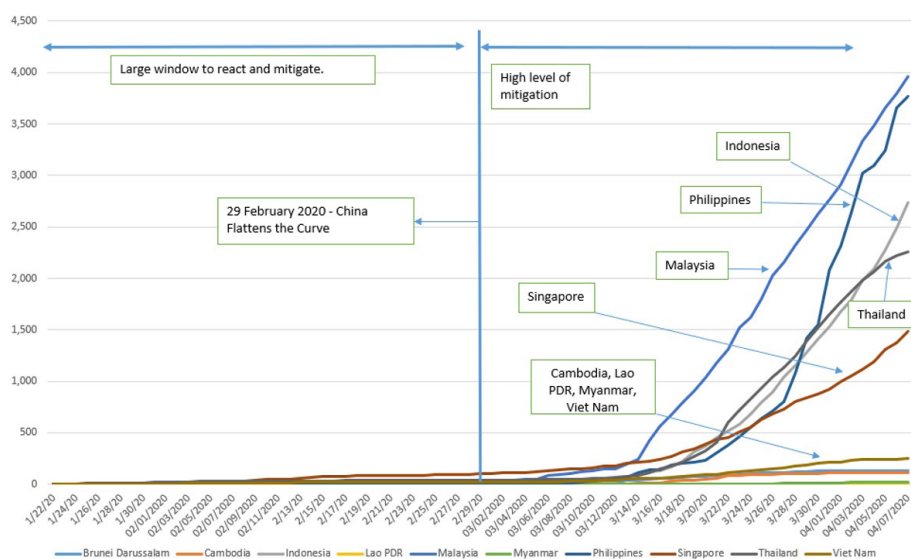
Critical to answering these questions is our understanding of how countries manage the health crisis and contain the spread of the disease, and how economic activities in the region have been governed so far.

Managing and containing the spread of COVID-19 depends on how swift or prepared a country is in responding to the pandemic (Kimura et al., 2020). The issue for AMS (except Singapore to some extent) is that they are late in responding to it – not utilising the lead time of about 1 month before the disease starts to spread in each country (Figure 1). These countries then face a higher risk of exploding disease transmission within communities, with greater pressure on the capacity of their national healthcare systems (e.g. ensuring sufficient medical supplies or test kits, or transforming buildings into emergency hospitals). Consequently, measures put in place are tougher, with stronger policies on social distancing leading to the lockdown of cities and economies.

Understanding the Regional Economy

The key to understanding the current state of the regional economy is comprehending the adoption of GVCs as crucial to production systems in the region. The value chain approach is unique to this part of the world, which is home to the most developed production networks in the world – reflected in the extensive participation by most economies and the degree of sophistication in the network structure (Kimura and Obashi, 2016).

Figure 1: COVID-19 Pandemic Curves – ASEAN Member States



ASEAN = Association of Southeast Asian Nations, COVID-19 = coronavirus disease.

Note: The date format on the horizontal axis is month/day/year.

Source: Johns Hopkins School of Public Health (2020), COVID-19 Pandemic. Novel Coronavirus (COVID-19) Cases Data. <https://data.humdata.org/dataset/novel-coronavirus-2019-ncov-cases> (accessed 8 April 2020).

GVCs have become more complex as decades of trade and investment liberalisation, high growth in infrastructure development, and the information and communication technology revolution have created increasingly interconnected regions. Modern multinational enterprises (MNEs) govern and manage the value chain network, running complex sets of activities which involve the exchange of inputs and various services, including professional services.¹

China has grown and transformed rapidly in the past couple of decades – becoming a powerhouse of the global economy, with connectivity to manufacturing and services activities in East and Southeast Asia.

Before its accession to the World Trade Organization in the early 2000s, China was not deeply involved in GVCs and its main export destinations were Hong Kong and Japan. In less than 2 decades, China has transformed to become a major GVC player in the region. By 2014/2015, China had become a principal supplier of inputs to many AMS, typically for downstream value chain manufacturing, while it was also a major importer of inputs from Japan or the Republic of Korea for its upstream value chain manufacturing (Chen and De Lombaerde, 2014; OECD, 2015). Figure 2 shows this in terms of exported value added traded by China and the AMS, which increased significantly over the period (2005–2015), earning China the label of ‘the factory of East Asia’.

¹ Other types of services in GVCs typically include services in design, marketing, and logistics; ownership of assets; enforcement of contracts and standards; technology transfer; and protection of intellectual property.

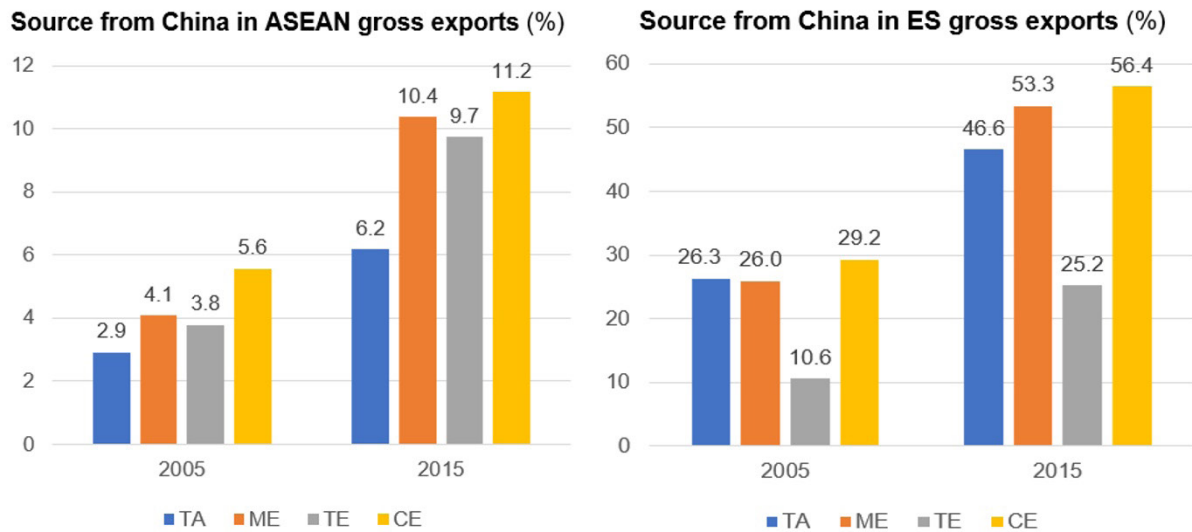
Impact and Implications

What, then, are the likely economic impacts and implications of the pandemic on the regional economy, especially with respect to regional economic governance?

One major impact is the disruption of supply chain performance in the region. With the major pandemic shock originating in China, the supply and demand of intermediate inputs by factories in China and the outputs of many AMS have been badly affected. This is exacerbated by disruptions to factories in Japan and the Republic of Korea, albeit to a lesser extent than in China. However, the supply side is not the whole story. With high expectations of a major global economic crisis, there will be a sharp drop in global consumer demand from the large negative wealth effect, which reinforces the supply-side effect and deepens disruptions to the GVCs. Thus, GVCs are affected from both the supply and demand sides of the regional and global economy.

Growth in connectivity – the key factor of a stronger GVC – has been disrupted by the pandemic and is expected to stagnate for the next few years as countries recover. Public investment, one of the drivers of the expansion in hard infrastructure projects for connectivity, is likely to be depressed in the near future because of the massive funding reallocation and new government debt stemming from reviving the national health systems and providing stimulus or social safety nets for people adversely affected by the downturn/recession. Thus, ensuring growth in connectivity is one of the critical challenges to be resolved in the post-pandemic era.

Figure 2: Share of GVC-Related Trade Between China and AMS, 2005 and 2015



AMS = ASEAN Member States; ASEAN = Association of Southeast Asian Nations; CE = computers, electronic, and electrical equipment; ES = East and Southeast Asia; GVC = global value chain; ME = machinery and equipment; TA = total; TE = transport equipment.

Source: Organisation for Economic Co-operation and Development, Trade in Value Added. <https://www.oecd.org/sti/ind/measuring-trade-in-value-added.htm> (accessed 19 March 2020).

Another likely impact is an increase in GVCs' operational costs due to the limited supply of services and the application of restrictive NTMs. Disruptions to the supply of services will likely result from more restrictive governance of the movement of professionals between countries, as one source of disease transmission is through the movement of people across borders. Countries are likely to apply NTMs to help manage the situation if a similar event occurs in the future.

Since our knowledge of COVID-19 is still nascent, countries could begin by raising the bar for sanitary and phytosanitary (SPS) food safety measures. Some AMS have imposed other forms of NTMs, such as export prohibitions on essential goods like medical equipment and masks, in response to concerns about supply shortages (Global Trade Alert, 2020). The uncertainty caused by the pandemic could force additional countries to apply more restrictive NTMs, which could become permanent if regional efforts do not monitor and control it. More restrictive NTMs increase the cost of inputs in the value chains for manufacturers.

The pandemic affects manufacturers operating in various sectors, especially those that are part of GVCs, and it may induce them to implement new strategies as they learn how to deal with the pandemic. The first strategy is the adoption of new technology. The pandemic causes decreases in both supply and demand, as noted above, but this is expected to recover at some point. When that happens, manufacturers investing in technology have a better chance of increasing production rapidly as demand picks up. This is possible because the disruption comes at a time when the manufacturing process has undergone rapid technological change through the introduction of automation and robotics (typical IR 4.0 technology).

Many manufacturers could bring forward the installation of new technology because of the pandemic. This is not uncommon, as evidence from other crises has shown the existence of this behaviour.² The pandemic could thus introduce a change that is permanent at the company level.

MNEs will also be impacted. One potential response is 'reshoring', i.e. transferring production activities (or value chains) back to home countries. Since the home countries are typically developed countries, reshoring is logical because the use of advanced technology is skill-intensive and labour-saving. Developed country governments could accelerate the process by providing incentives, partly because of the recognition of the inherent risks of massive supply disruptions to fragmented production networks.

Another possible response from MNEs is to consolidate their activities in the countries of consumption of their products. Such consolidation reduces the risk of a breakdown in value chains if another crisis of a large magnitude occurs, although it increases inefficiency because it relies less on international production networks. Consolidation is less damaging than reshoring, but it only favours countries with high growth potential.

² For example, the International Federation of Robotics (2019) reported that restructuring by automotive firms after the 2008/2009 recession increased the pace of robotics installations amongst automotive manufacturers and parts suppliers.

In the end, reshoring and consolidation pose a credible threat to many developing AMS, and policymakers in the region need to respond appropriately. This is another substantial challenge for ASEAN in the post-pandemic period.

Short-term Policy Implications

The likely economic impact and implications of the pandemic reveal some room for deepened regional cooperation and a stronger regional commitment to advancing liberalisation and facilitation measures in several areas. Before outlining these, it is important to recognise that swift economic recovery depends greatly on whether countries in the region can contain the spread of the disease successfully and quickly. The extent of the economic cost for the recovery period largely depends on how countries in the region manage the health crisis.

Policy coordination between countries is urgently required to help prepare for and mitigate the spread of the disease. Preparedness is an important variable in choosing a containment strategy because it determines the options available to governments. Although no country has been particularly well prepared for this pandemic, some countries have responded better than others. Policy coordination in this case can focus on risk management, which covers the key elements of preparedness, including (i) identifying the characteristics, magnitude, stages, distribution, and periods of the epidemic in each scenario; (ii) performing gap analysis; (iii) mapping out needs based on priorities (this will be helpful to estimate fiscal needs); and (iv) making efforts to fill the gaps.

It is important to note that policy coordination to manage the disease needs to be in agreement with social security systems at the country level. These important mitigation measures create externalities (adverse impacts), such as loss of income because of lockdown measures or sudden increases in people's medical costs, which governments need to absorb.

Countries' Commitments to Facilitate a Swift Recovery

Once the spread of the disease is under control, a number of commitments should be in place between countries to facilitate a swift recovery. These should at least cover the following areas.

First, **connectivity**. This commitment should focus on ensuring sustained connectivity (both hard and soft) between countries. Connectivity may even need to be deepened and widened to reduce the costs of maintaining GVCs in the region. As stated above, some adverse impacts may remain after the pandemic (i.e. in the form of more restrictive regimes for the movement of professionals/workers and in terms of SPS measures), and these may contribute to increased GVC costs throughout the region. For hard infrastructure development, workable mechanisms to

facilitate public-private partnerships are urgently needed, since many countries' budgets are likely to remain in recovery mode – emerging from huge deficits amassed in 2020 for the pandemic relief and stimulus packages. Countries in the region should increase reliance on private sector investment, at least in the medium term, after the pandemic.

Second, **trade liberalisation and facilitation**. With tariffs at a low level, the agenda should focus on the simplification, harmonisation, and streamlining of NTMs based on concrete statistics; and careful cost-benefit consideration. This will ensure that measures put in place during or shortly after the pandemic are removed if no longer necessary. Countries in the region also need to be transparent regarding the establishment and application of measures after the pandemic – to ensure that such measures do not affect the flow of goods, which could affect economic recovery and the recommencement of GVCs. If measures are legitimate, they should be administered in a way that minimises their impact, especially on small and medium-sized enterprises.

However, as noted, NTMs could be more restrictive after the pandemic. Countries should follow the principles set by the World Trade Organization; and the extent of the measures, including SPS restrictiveness, should be gradually reduced as knowledge from scientific research becomes available over time. Another initiative under trade is to ensure openness in air transport services, especially for freight. If necessary, freight air transport services could be made more open than under the current regime because the supply of passenger air transport services might be lower. Restrictions on the movement of professionals or workers after the pandemic could spill over to the freight side of air transport services. Deeper air transport service liberalisation for freight is therefore necessary to counterbalance the potential reduction in passenger services (as some freight is carried on commercial passenger aircraft).

Third, **investment liberalisation and facilitation**. Investment regimes for countries in the region, especially the AMS, need to be significantly more open after the pandemic. This will maintain the attractiveness of AMS for MNEs and foreign investment in general, and help revive companies that went bankrupt during the peak of the crisis caused by the pandemic.

This is important for at least three reasons. First, it will reduce the incentive for MNEs in developed countries and China to reshore. As noted above, lack of absorptive capacity in many developing AMS inhibits MNEs from quickly adopting new technologies that rely on automation and robotics (IR 4.0 technology). The utilisation of such technology is still low and concentrated in a few industries (Figure 3). In the longer term, AMS should accelerate reforms to help workers in these countries attain the skills which will be in high demand as new technology is adopted in the future.

Figure 3: Utilisation of Robotic Technology in Southeast Asia, 2000–2016



Source: International Federation of Robotics, World Robotics Database (various years).

Second, it will help counteract reshoring by encouraging MNEs to balance their investment portfolios. One lesson learned from the pandemic is that MNEs may wish to reduce their over-reliance on China by widening their value chains to countries other than China. This is an expansion of the ‘China Plus One’ strategy to ‘China Plus Two or Three’.

The third reason to open up investment regimes is to deepen the liberalisation of services. Modern GVCs incorporate services in complex value chains, but the pandemic has taught us that lack of high-quality services within countries contributes to the failure of GVCs during crises. This also applies in AMS, as these countries were increasingly connected to value chains before the pandemic. The service sector under the AEC is yet to be comprehensively liberalised. AMS could use the post-pandemic recovery as momentum to liberalise the sector, with a view to strengthening the survival capacity of GVCs in the ASEAN region.

What Can ASEAN Do?

Actions by Southeast Asian countries under ASEAN are critical for the region to respond to and act on the recommendations outlined above. The basic principle is for ASEAN to leverage long-established and solid associations between its Member States, and between the AMS and Dialogue Partners, and to use them to realise all the recommendations. The ASEAN Community (Economic and Socio-Cultural) is the natural platform for this, especially because the need to cooperate with East Asian countries (the Dialogue Partners) is well embedded in the Community blueprints.

On the economic front, ASEAN could accommodate all the above recommendations through discussions with relevant bodies under the AEC. It could also use the momentum for reviving the regional economy after the pandemic to revisit the framework adopted by the current blueprint (AEC 2025) and adapt it to the more complex GVC model. Thus, the next AEC blueprint should be significantly more comprehensive and resilient to economic shocks.

For the Socio-Cultural Community, strengthening initiatives in several areas is warranted to better prepare AMS for similar events in the future. Social protection and insurance schemes, which are increasingly integrated into the broader natural disaster response under the ASEAN Socio-Cultural Community, could be strengthened. A comprehensive and responsive system must be developed in ASEAN through effective policy coordination.

All in all, it is a challenging time for global economies, including countries in East and Southeast Asia, which have long embarked on regional integration. Looking ahead, it is important for countries to improve coordination with others to prepare for similar shocks. For countries in the region, this could be led by ASEAN through the ASEAN Communities and under the framework of ASEAN Plus Six (EAS). Initiatives under the ASEAN Community blueprint could be revisited and deepened, based on lessons learned and possible impacts and consequences of the COVID-19 pandemic.

The policy directions proposed above reflect a responsive ASEAN and should help the member states and other countries in the region to overcome challenges from other crises or pandemics in the future.

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 **Economic Research Institute for ASEAN and East Asia**
Sentral Senayan 2, 5th and 6th floors
Jalan Asia Afrika No.8
Senayan, Central Jakarta 10270, Indonesia
Tel: (62-21) 57974460
Fax: (62-21) 57974463
E-mail: contactus@eria.org