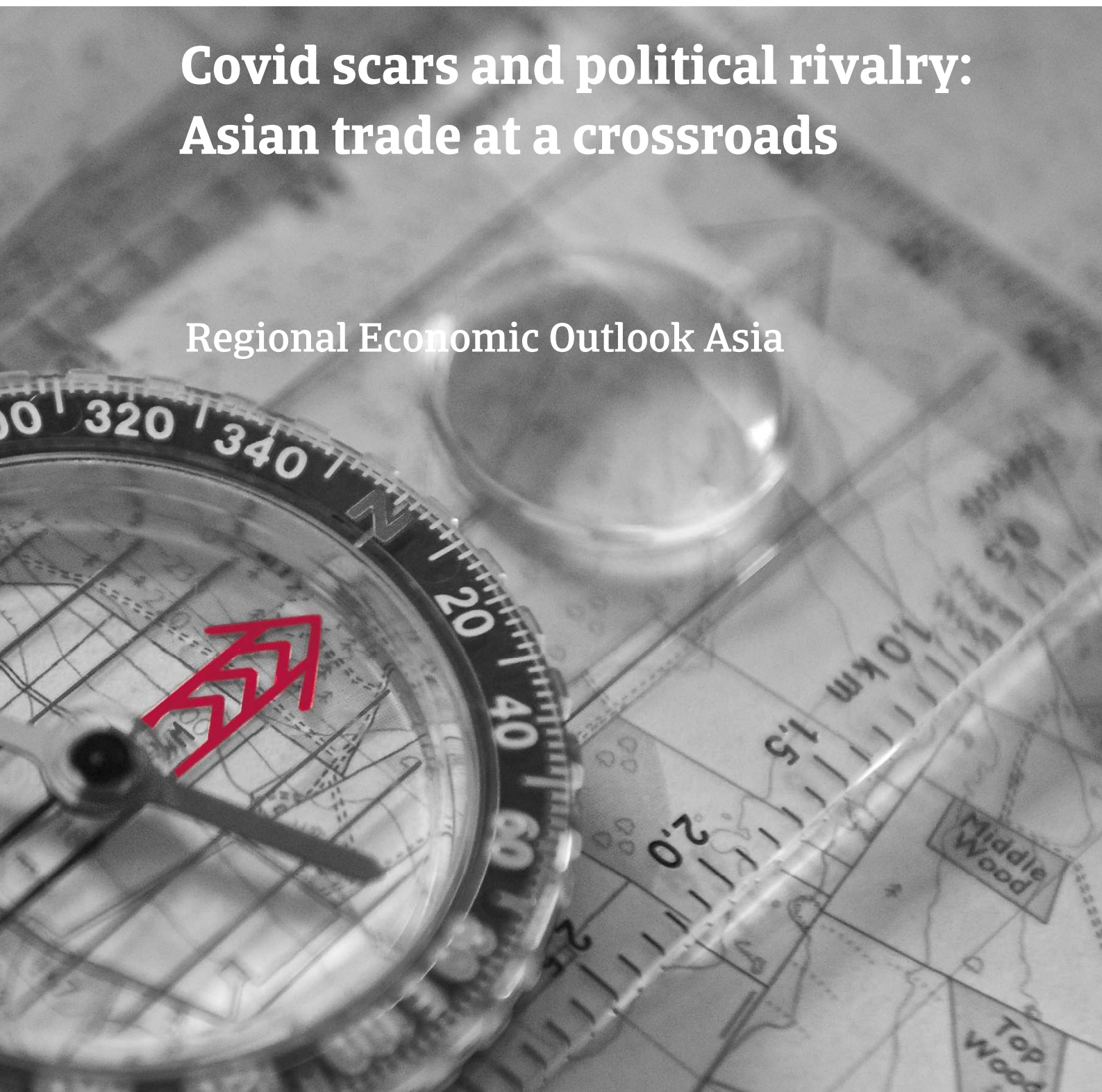


# Covid scars and political rivalry: Asian trade at a crossroads

Regional Economic Outlook Asia



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# Executive summary

**A year and a half after the start of the Covid-19 pandemic, Asia is looking ahead. The economic recovery has started and companies are trying to normalise their operations. However, the business environment seems more risky than it was a few years ago. What is the long-term impact of the pandemic? What will public and business leaders do now that Covid-19 and the trade war have raised their awareness of the vulnerability of global supply chains?**

In this publication, we first look at the impact of the most recent Covid-19 wave on macroeconomic developments in the region. It turns out that the economic recovery is slowing only temporarily, and the most in the countries with relatively low vaccination rates. Exports are an important driver of the economic recovery in several, but not all countries. In the second part, we take a closer look at the outlook for foreign trade, focusing on supply chain disruptions, the scars from the pandemic and the effects of the trade war. The pandemic has raised internationally operating companies' awareness of the vulnerability of their supply chains. They must weigh financial and economic considerations against their goal of mitigating risks. Meanwhile, the ongoing US-China trade war is impacting supply chains. Looking at trade flows, we have investigated the extent to which there is a decoupling of the Chinese and US economies.

Our base scenario, also outlined in the (Global) Economic Outlook published in August, is that the economic recovery, both globally and in Asia, will continue. Foreign trade in Asia will also pick up, and in many countries will be the main driver of growth. However, besides new, more transmissible Covid-19 variants, lasting scars from the pandemic and geopolitical rivalry are bringing a less favourable long-term scenario closer. Whether corporate decision-makers opt for optimal efficiency or for reducing vulnerability, and whether governments choose cooperation over rivalry, will have a significant impact on future trade patterns in the region and beyond.

## Key points

- Record numbers of new Covid-19 cases slow the economic recovery in Asia, but only temporarily and mainly in countries with a low percentage of the population that is fully vaccinated.
- China and Vietnam show highest growth in Asia since the outbreak of Covid-19. India's economy, despite high growth rates, is likely to experience a setback. Economic activity in Thailand and the Philippines will not reach pre-pandemic levels before 2022.
- Rising exports are contributing to the recovery in most countries, with Vietnam and China taking advantage of a global boom in demand for computers and electronics.
- Vietnam will also benefit from the ongoing US-China trade war, with a strong recovery in FDI inflows. The trade war has not resulted in a significant decoupling of the US and Chinese economies.
- The direct impact of supply chain distortions will disappear, but the pandemic will leave scars with long-term implications for growth and international trade. India and the Philippines will suffer economic scarring the most, while Vietnam and Taiwan probably feel it the least. Differences in the containment of the Covid-19 outbreak and the level of fiscal support are the main explanatory factors.
- Companies will rethink and redesign their supply chains because of the disruptions that have led to shortages of essential commodities around the world and increased costs. For governments this is, together with the trade war, a reason to place more emphasis on self-reliance in crucial sectors such as high-tech and pharmaceuticals.
- Free trade agreements offer some counterbalance to these developments. Like trade policy in general, however, they are increasingly tools of geopolitical aspirations and less inspired by the pursuit of economic cooperation.

# Making supply chains less vulnerable

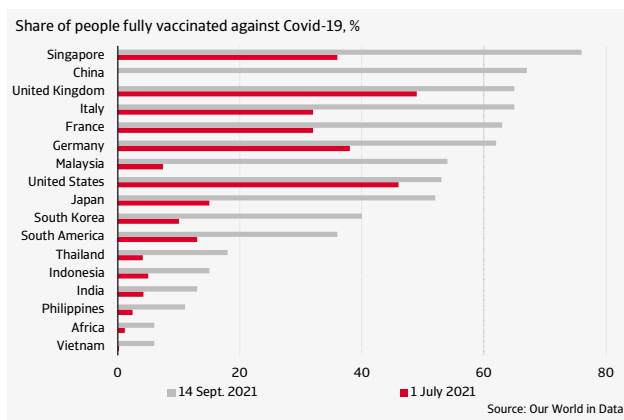
## Economic recovery is losing momentum, but not for long

The economic outlook for Asia has changed. Owing to a surge in Covid-19 cases and renewed lockdown measures the robust recovery that started in 2020 is losing momentum. Most economies show declining or negative GDP growth rates. The slowdown, however, should not last long. Economic recovery is forecast to pick up again in the coming quarters and Asia to resume its normal position as the world's fastest-growing region. The growth prospects for the various Asian economies are not quite the same. The vaccination rate, which differs from country to country, appears to be the main explanatory factor. Fiscal policy and foreign demand are – more or less - the main growth drivers over the remainder of 2021 and in 2022.

### Covid-19 strikes again

Many Asian countries<sup>1</sup> have been relatively successful in containing the Covid-19 pandemic until this summer, due to strong measures, taken soon after the first outbreaks. With vaccinations, however, Asia was relatively slow. Whereas in many developed countries in Europe and North America by early July one third to one half of the population was fully vaccinated, Japan (15%), South Korea (10%) and China (not publishing official data earlier this year), were clearly lagging behind. India and the ASEAN-5 were doing even worse, with vaccination rates between 7% and 1%.

#### 1.1 Vaccination rates rise, but vary widely

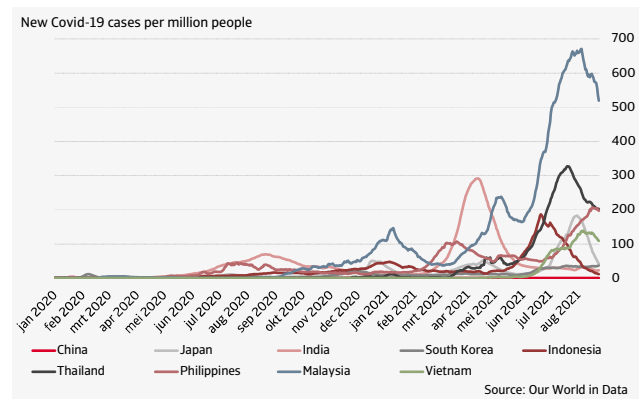


About three months later, India and most ASEAN countries are catching up, but still a relatively low share of the

<sup>1</sup> The focus of the Regional Economic Outlook is on China, Japan, India, South Korea and the biggest five economies of the

population are fully vaccinated. China, Malaysia, Japan and to a lesser extent South Korea are nearing the western countries' levels of vaccination, but – like the other countries – now see the effects of the slow-start of their vaccination campaigns working through to the economy.

#### 1.2 Rising numbers of Covid-19 cases, but not everywhere



It was the outbreak of the highly contagious Delta variant that has led to a rapidly rising number of cases in Asia. Indonesia saw record numbers of new cases in July, followed by Malaysia and Thailand in August, resulting in new containment measures. The Philippines, experiencing a third wave in September, extended restrictions in the Manila area and some hot spot provinces. Vietnam, which had successfully contained earlier spikes, is also struggling with record-high numbers, with the highest in three main industrial hubs in the southern part of the country. In China the number of new cases remained low, but because the pandemic spread to large parts of the country, authorities decided to impose local lockdowns and travel restrictions.

### China and Vietnam keep up steam, Philippines and Thailand lagging

The spread of the Delta variant and the associated restrictions have a negative effect on economic activity in the entire region. Zooming in on current developments and growth prospects for the various economies it turns out that the economic recovery will pick up again, though there are clear differences.

Association of South-East Asian Nations (ASEAN): Indonesia, Thailand, Philippines, Malaysia and Vietnam.



**China's** growth momentum weakened in July and August, mainly due to a sharp fall in infrastructure investment and to a lesser extent in manufacturing and real estate. Covid-19 did not have a big impact, though China's 'zero-tolerance' approach to outbreaks has led to caution among both consumers and businesses. Unrest about problems in the real estate sector related to the Evergrande crisis probably will contribute to that. Still, a pick-up in growth in Q4 2021 is likely, which will bring GDP growth to 5% year-on-year. Consumer spending is expected to recover with the current outbreak brought under control and helped by the unwinding of excess savings. Meanwhile, better profitability and policy support to SME's, the advanced manufacturing sector and strategic high-tech industries will help business activity. Export growth slowed over the summer, but the outlook for next year remains robust. While the shift in global demand away from goods towards services will dampen China's export growth, its role in global supply chains remains intact, and strong demand for electronics should persist. A downside risk for the Chinese economy is the geopolitical rivalry with the US and countries like India, Japan and Australia. Increasing tensions, because of strong pressure from western countries for economic policy changes, could have a negative impact on foreign trade as well as on GDP growth.

**1.3 Growth outlook remains good, despite new Covid-19 cases**

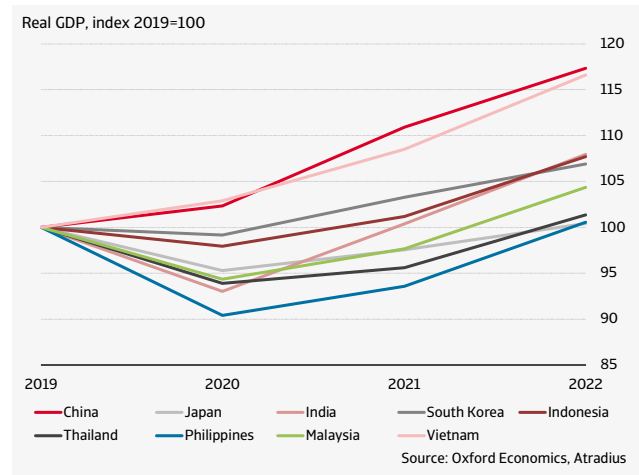
Real GDP growth (%) - Asia

	2020	2021	2022
China	2.3	8.4	5.8
Japan	-4.7	2.4	2.9
India	-7.0	7.9	7.5
South Korea	-0.9	4.2	3.5
Indonesia	-2.1	3.3	6.4
Thailand	-6.1	1.8	6.0
Philippines	-9.6	3.5	7.5
Malaysia	-5.6	3.5	6.8
Vietnam	2.9	5.4	7.5

Sources: Oxford Economics, Atradius

For **Japan**, the economic impact of the new wave of Covid-19 infections over the summer is relatively moderate. Consumer spending showed resilience, despite the state of emergency in major cities, while capital investment surveys also showed a moderately positive development. Export data were strong in the first half year, thanks to strong global demand for machinery goods, though a flattering comparison with last year's pandemic-induced slump played a role as well. Over the coming twelve months the Japanese economy will probably gradually strengthen further. Subdued wage growth keeps consumer spending at a modest pace, while supply chain disruptions should slow export growth. A vaccination rate that is finally catching up to other developed countries and continued fiscal and monetary policy support are expected to keep the recovery on track, though real GDP won't reach its pre-pandemic level before 2022.

**1.4 Some countries reach pre-pandemic level not before 2022**



In **India**, a second wave of Covid-19 infections and local lockdowns put the economy on a rollercoaster, with a sharp contraction in the second quarter, and - since the authorities chose to reopen the economy rapidly - a strong rebound in the third quarter. Economic activity probably will strengthen further, due to a recovery in private consumption and business investments, and an anticipated recovery in external demand. The high growth rate expected for 2021 as a whole, however, is mainly due to last year's low base, when the first wave sent the economy into a deep recession. Because household and corporate balance sheets have weakened and the government needs to rein in its expenditures, the economy is prone to setbacks. Private consumption and business investments also may weaken again should there be a third wave, which is a real risk with vaccinations still at a low level. Exports will show a recovery, but should be outpaced by imports.

**South Korea's** economy is quite steady. Recent data hardly show headwinds of rising new Covid-19 cases. Restrictions will weigh on private consumption, but with a relatively high share of the population fully vaccinated these probably will be withdrawn quite soon. Fiscal support for the economy will remain strong through the rest of the year, which is helpful for both private consumption and business expenditures. External demand should also remain resilient. Robust demand for semiconductors and a rebound in global trade will prove key drivers for this. Weakening demand from China and supply-chain constraints are downward risks to exports of goods, but GDP growth will probably remain well above 3%.

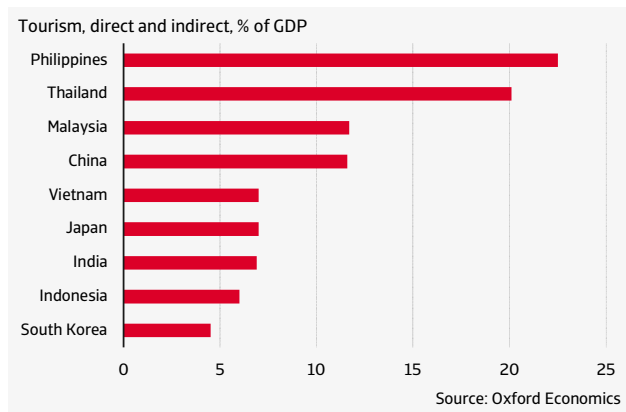
Like South Korea, **Indonesia's** economy experienced a relatively small contraction last year, followed by a recovery in the first half of 2021. Growth momentum however has fallen because of tight restrictions after a rise in Covid-19 cases this summer. Both private consumption and business investments contributed negatively in the second and third quarters and also export-oriented sectors were hit by the latest lockdown measures. Accommodative fiscal and monetary policies can prevent the economy from falling back into a recession, but growth probably will begin to accelerate only next year, when a sizeable share of the population will have been fully vaccinated. Also for

Indonesia, falling industrial demand from China and a related fall in commodity prices are downside risks for exports, of which commodities account for over half.

With travel and tourism at 20% of total GDP, ongoing travel restrictions in **Thailand** were a drag on growth both during last year's recession and this year's recovery. Several destinations have reopened to quarantine-free travel, but requirements by travellers' home countries, in particular China, will limit tourism during the rest of the year at least. Meanwhile, global chip shortages have led to supply chain disruptions in the automobile and electronics sectors, which prevent manufacturing and export to support growth. The recovery will gain momentum by mid-2022, once a large part of the population is fully vaccinated, tourism numbers pick up and the impact of supply chain disruptions decrease. With limited space for monetary stimulus, the government probably will introduce more fiscal support to the economy and will also spend more on infrastructure.

Like Thailand, the **Philippines** is still feeling the negative impact of travel restrictions on its tourist sector. A renewed fiscal package, however, will support domestic demand next year. The government wants to stimulate consumer spending with a cash handout, while extra infrastructure spending is helping the construction sector. Goods exports have fared much better than services exports recently, but the Delta variant and regional supply chain bottlenecks cloud the outlook in the near-term.

### 1.5 Philippines and Thailand most affected by fall in tourism



**Malaysia** has probably fallen into a technical recession in the third quarter, though not as deep as last year. Besides containment measures, supply chain disruptions and lower external demand have slowed the economic recovery quite abruptly. The outlook, however, is quite good. Because Malaysia has made good progress with its vaccination programme, the new government probably will not deviate from the current Covid-19 recovery plan. Income support measures will stimulate consumer spending, while an upswing in the global electronics cycle and ongoing demand for pandemic-related goods will support exports this year and next.

Together with China, **Vietnam** is the only other relatively big economy in Asia with no GDP contraction in 2020 and high growth rates in both 2021 and 2022. The recent wave of Covid-19 cases has led to tight restrictions in major cities and

the shutdown of several factories, which led to a drop in economic activity in the third quarter. However, the economic recovery continues, driven by a thriving export sector. With strong foreign direct investments and a stable political environment Vietnam is benefitting from rising global demand for electronics, an industry in which it participates in many global supply chains. The global chip shortage and tighter restrictions will weigh on manufacturing and services in the short term, but a solid rebound is on the cards for the last quarter of this year. Vietnam, more than other countries, is benefitting from the US-China trade war, with US imports shifting away from China (see also figure 1.6). A downward risk could be higher tariffs on exports to the US, since the Trump administration designated Vietnam a currency manipulator in December 2020. In the current situation, however, the US probably does not have the appetite to further disrupt its own companies' supply chains. In addition, the new president is aware of Vietnam's strategic importance in countering China's influence in the region.

## Long-term trade outlook clouded by political rivalry

The recent Covid-19 wave may not be an obstacle to further economic recovery, but trade to, from and within Asia is still subject to supply chain disruptions. In addition, the pandemic is leaving lasting scars and the US-China trade war continues. While the short-term prospects for Asian trade – as described above – in most countries are good, these negative factors will have an impact on the outlook for 2023 and beyond.

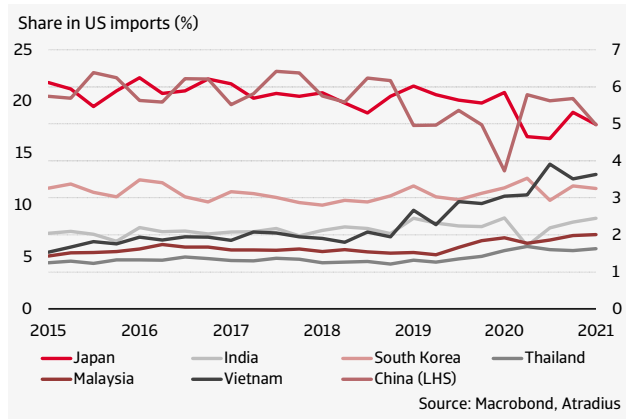
## Supply-chain disruptions will ease, while demand remains strong

Covid-19 has led to some of the largest reductions in international trade volumes since the Second World War, both globally and in Asia. Goods trade fell sharply as demand for both consumer goods and capital goods declined. Somewhat uniquely, trade in services fell even more, related to the travel restrictions implemented worldwide. As mentioned, in Asia it was the countries with a relatively large tourism sector that suffered from this the most.

Still, not all kinds of international trade showed a decline. Lockdowns led to fewer sales of clothing, cars and fuel, while the close of businesses put a brake on the production of aircrafts, mechanical machinery and steel. Trade in some other products, however, increased, like protective equipment and pharmaceutical products, food, and products that can be used for working from home, such as consumer electronics. This increased demand for specific goods allowed China, Vietnam, and to a lesser extent Malaysia and Thailand to increase their share of imports of the US and of other destination countries. For China, this even marked an end to the declining trend in its US imports share that took place during the Trump presidency, which started in 2017.

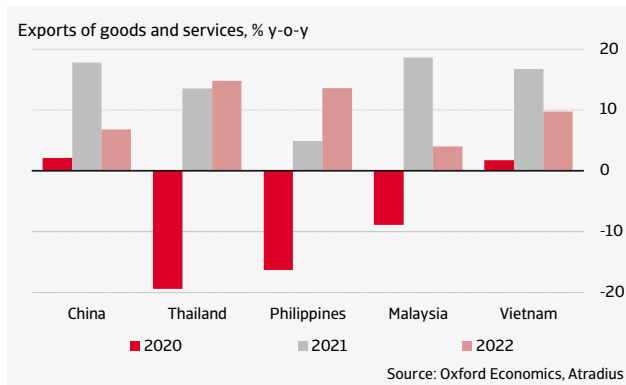
The import share of Vietnam, benefitting from the trade war, clearly rose already before 2020.

**1.6 Several countries see their share of US imports rising**



China's aggregate exports were already recording positive year-on-year growth rates in July last year, less than half a year after the pandemic started to have an impact. In South Korea and Malaysia exports rebounded in the second half of the year. Japan's exports started to recover in November 2020, though at a relatively moderate rate. The Philippines followed with exports recovering at the beginning of 2021. Apart from the differences between the various countries, it can be said that Asia could fill many supply gaps left by countries in other parts of the world.

**1.7 Supply chain disruptions did not prevent exports to recover**



While the supply chain disruptions caused by lockdowns obviously did not prevent Asian exports from recovering, the extraordinarily rapid rebound has led to severe transport-related bottlenecks. Congestion in many of the world's key ports, together with shortages of semiconductors and new lockdowns in some countries, have caused global trade growth, particularly of manufactured goods, to slow recently. However, since bottlenecks are intrinsically transitory, these pressures may begin to ease in the latter stages of this year. Problems in the shipping industry will take longer, but will partly be offset by diversification of suppliers and production outlets. Meanwhile, demand from China, the US, Europe and also from Asia itself, remains solid, fuelled by the easing of restrictions, consumers' accumulated excess savings and ongoing fiscal and monetary support. Services trade, in particular travel and tourism, is recovering at a

slower pace than goods trade. But here too, further recovery is to be expected as vaccinations increase.

**Economic scarring brings permanent output loss**

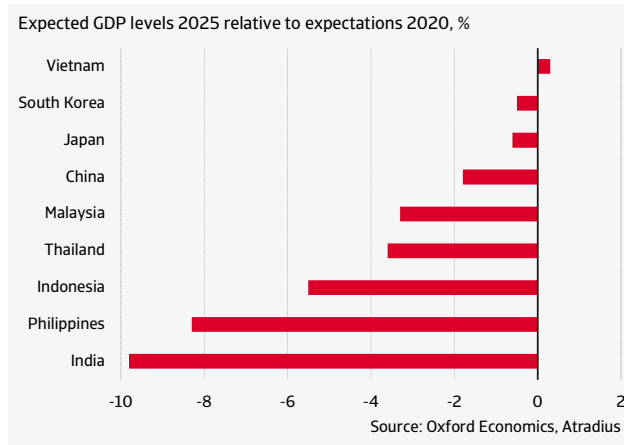
Supply chain disruptions receding into the background does not mean that the pandemic has not caused lasting damage to Asian economies. This so-called economic scarring – a term currently widely used in analysis and discussion of the macroeconomic impact of the pandemic – refers to the lasting consequences of the recession on the economy and, consequently, international trade. Economic scarring manifests itself in lower capital outlays, less labour supply and lower technology growth if households and firms save more and governments put more focus on fiscal consolidation. Worldwide, government measures have limited the erosion of employee skillsets and the dismantling of businesses. This has been crucial for the supply side of the economy in order to remain more or less intact, and to avoid a situation where pent-up demand in the recovery cannot be met by supply. But the longer the pandemic lasts, and the larger the impact remains, the more scarring occurs.

Despite the relatively bright outlook for Asia in the coming quarters, most economies suffer permanent output loss from the pandemic. According to the IMF in its recent World Economic Outlook, the prospects for economic scarring from Covid-19 are substantial, even if less than after the global financial crisis. Global output in 2024 is expected to be about 3% lower than anticipated before the crisis, assuming that the pandemic is brought under control globally by the end of 2022. The IMF calculations show the degree of expected scarring varies across countries, depending on the structure of economies and the size of the policy response. Whereas advanced economies – because of their huge fiscal support schemes – will see about 0.75 percentage point less growth on average, the loss for emerging market economies on average will be about 4.25 percentage points (and for the low-income countries even more than 6 percentage points). The largest impacts of the crisis are on the most tourism-dependent economies. Countries that supported their economies with large pandemic-related fiscal measures are projected to experience smaller losses.

While the IMF has limited itself to drawing more general conclusions, it is worth translating the consequences of economic scarring to the various countries in Asia. Looking at expected GDP levels in 2025 relative to what has been expected last year, India, the Philippines and Indonesia have the most scarring, while Vietnam's GDP in 2025 is expected to be higher than was expected before the pandemic. The main explanation for India and the Philippines is that both economies are experiencing large losses given sharp falls in investment and higher unemployment rates, while the fiscal response has been relatively meagre. The elevated numbers of Covid-19 cases in both countries and in Indonesia are also explanatory, especially regarding a relatively low percentage of the work force that are office workers (who can work from home) or is employed in the manufacturing sector, where many production sites stayed in business. For Indonesia as

well, relatively meagre fiscal support is playing a role. Thailand and the Philippines, as mentioned before, are seeing a lot of permanent output loss because of their reliance on tourism.

### 1.8 Economic scarring entails significant loss of output



A special case, not shown in the graph, is the Taiwanese economy. Successful containment of the Covid-19 outbreak resulted in less economic scarring. In addition, the economy benefits from reshoring of manufacturing by Taiwanese multinationals. Especially the semiconductor industry has increased its production capacity to respond to strong demand from the US and other countries.

We expect strong GDP growth in the coming years, of 5% to 6% annually for the region as a whole. However, with Covid-19 having a lasting negative impact on most of the Asian economies, GDP volumes on average could be about 3% lower in 2025 than implied by pre-pandemic projections.

## Mitigating risk, at the cost of efficiency and profitability

An important kind of economic scarring of the Covid-19 pandemic comes from companies rethinking and redesigning their supply chains because of the disruptions that have led to shortages of essential commodities around the world. The pandemic has raised internationally operating companies' awareness of the vulnerability of their supply chains. As they look to mitigate risks that may arise from future external shocks, corporate leaders will make adjustments to their business models that are expensive and may come at the cost of their efficiency and profitability. This exchange of efficiency for resilience will also have an impact on foreign trade, because these risk mitigation strategies could imply that businesses choose to rely more on supply of commodities and intermediate goods from nearby countries or regions. The pandemic therefore will probably strengthen the onshoring trend that started during the US-China trade war.

## No end in sight for US-China trade war

The combination of pandemic and trade war has also prompted governments around the world to question their country's reliance on foreign suppliers and international production networks. Worries about the supply of key medical goods made in the initial phase of Covid-19 as well as current shortages of chips are a reason to place more emphasis on self-reliance in crucial sectors such as high-tech and pharmaceuticals. But even more than these pandemic related considerations, the grimmer geopolitical situation that has arisen in recent years may have a negative impact on global trade.

A three decades long period of globalisation has facilitated the geographic diversification of supply chains away from domestic markets. Improved technology and innovations have enhanced logistics, while investment liberalisation and free-trade agreements lowered the barriers between countries. From an economic point of view these developments have been good, since international trade facilitates use of the countries' comparative advantages, which is the economy's ability to produce a particular good or service at a lower opportunity cost than its trading partners. Asia, being at the heart of global supply chain developments, has benefitted enormously in the last few decades from the increase of international trade.

The US-China trade war and geopolitical rivalry seem to have ended this trend. With a new president in the White House, US trade policy has become less volatile than in the preceding four years, but the trade war is far from over. The hard line has bipartisan support in the US, which meant that both tariffs and non-tariff barriers remained in place. Meanwhile, the EU has become also more critical of China's trade policies and practices. Due to political tensions about sanctions imposed on officials on both sides, the ratification process of the important Comprehensive Agreement on Investment (CAI) has been frozen. A full-blown trade war between the EU and China currently is unlikely, but since most EU members are converging on the view that China should be seen as a systemic rival instead of a trade partner an improvement of the trade relationship is not on the cards.

China, meanwhile, is showing few intentions to improve the relationship with the US and has an ambiguous strategy towards the EU, trying to build relationships with individual member states by direct investments and sending mouth masks in the early phase of the pandemic, while also threatening the EU with sanctions. China's current trade policies and practices at first sight are ambiguous as well: on one hand there is a focus on innovation and market reform, while on the other hand on self-sufficiency and national security. Related to the first two priorities, the government puts strong emphasis on strengthening innovative capacity in the strategic fields of 5G, the 'internet of things' and cloud computing. Part of this is a commitment to a level playing field for foreign companies. However, regarding the poor relationship with the US and increasingly the EU, the focus on self-reliance and national security will have the upper hand. This means, among other things, that the Chinese

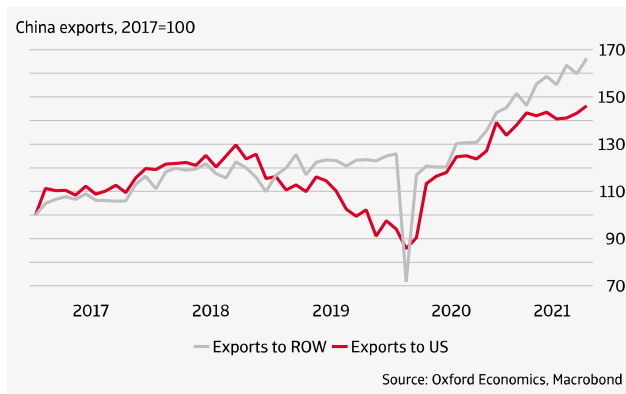


government will continue to curb foreign investment and force foreign companies to exchange market access with technology.

### No significant decoupling yet

Decoupling has become the buzzword to describe a possible economic break-up between the US and China. A complete disintegration of the world's two largest economies, however, is unthinkable. The economic context of the trade conflict is fundamentally different from the situation during the Cold War, when East and West had hardly any trade relationships. Now, the US and Chinese economies are strongly interconnected and separating them entirely would harm both countries – and the global economy – tremendously. Still, tariffs and other trade barriers have had an impact on specific trade categories. The figure below shows that Chinese exports to the US fell from early 2018, when former US president Trump started to heat up the trade war, while exports to the rest of the world were rising moderately. But then, when the Covid-19 pandemic started, Chinese exports grew strongly, both to the US and to other destinations, followed by a slowdown in 2021. Though the low base in 2019 explains part of the steep rise in 2020, strong demand for Chinese products was the main reason for it. The coming years will show whether the trend of 2018/2019 will resume. However, the impact of the ongoing trade war, obviously can be overruled by other developments.

#### 1.9 US-China decoupling interrupted by Covid-19



## Free-trade agreements overshadowed by political rivalry

China's policy of making the economy more self-reliant clearly does not stand in the way of several initiatives to strengthen trade ties with other Asian countries. The rationale behind this is clear. China is the largest trading partner of almost all the countries in the region and could benefit much from free-trade agreements. The Regional Comprehensive Economic Partnership (RCEP) probably is the most important trade agreement China has signed. It brings China together with the ten member states of the ASEAN and several other countries in the Asia-Pacific region: Australia, Japan, New Zealand and South Korea. Recently, China has also applied to become part of the other large trade pact, the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). That deal, which also includes countries on the other side of the Pacific, was originally called the Trans-Pacific Partnership and was meant to include the US as well. But the US withdrew from the TPP even before it started. CPTPP is seen as more important than RCEP, but it is unlikely China will be admitted, because countries like Canada and Australia, that got punitive trade measures during various diplomatic disputes, can block it. Japan, which initiated the restart of the trade initiative, stated that China's chances to join are very low because it does not meet the conditions. The fact that China knows about the small chance for admission, makes it plausible that the request was politically motivated. Together with the request of Taiwan to participate in CPTPP, the current pact members have entered a politically delicate situation. Like the ongoing trade war, it shows trade policies are increasingly used as an instrument for geopolitical aspirations and less inspired by the pursuit of economic cooperation.

The outlook for economic growth and trade in Asia is good. The impact of supply chain disruptions will ease and the economic recovery will gain momentum again. Though economic scarring has created permanent losses, strong GDP growth in the coming years is still likely. The long-term trade outlook, however, is clouded by the ongoing trade war. Whether governments choose for cooperation or for rivalry, will have a significant impact on future trade patterns in the region and beyond.

