WORLD BANK EAST ASIA AND PACIFIC ECONOMIC UPDATE OCTOBER 2021

LONG COVID

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Executive Summary

The East Asia and Pacific (EAP) region is suffering a reversal of fortune. In 2020, many EAP countries successfully contained COVID-19 and economic activity swiftly revived as other regions struggled with the pandemic and economic recession. Now the region is being hit hard by the COVID-19 Delta variant while many advanced economies are on the path to economic recovery.

The disease is damaging the economy and is unlikely to disappear in the foreseeable future. In the near term, the persistence of the pandemic will prolong human and economic distress unless individuals and firms can adapt. In the longer term, COVID-19 will reduce growth and increase inequality unless the scars are remedied and the opportunities grasped. Policy action must help economic agents to adjust today and make choices that avert deceleration and disparity tomorrow.

What Is Happening Now?

The uneven recovery in the EAP region is now facing a setback. China is projected to grow at 8.5 percent in 2021, though growth momentum has eased. Overall regional growth is projected at 7.5 percent, reflecting the scale of China's economy. The rest of the region is anticipated to grow by 2.5 percent, compared to 4.4 percent forecast in our April update, with significant heterogeneity across countries. While China, Indonesia, and Vietnam have already surpassed pre-pandemic levels of output, Cambodia, Malaysia, and Mongolia will only do so in 2022, and the Philippines, Thailand, and many Pacific Islands will remain below pre-pandemic levels of output even in 2023.

As a result, employment has declined, poverty will persist and inequality is increasing across several dimensions. Regional employment rate dropped by about 2 percentage points on average between 2019 and 2020. As many as 24 million people will not be able to escape poverty in 2021 in developing EAP, excluding China, because of COVID-19. While all households have suffered, poorer ones were more likely to lose income, sell off productive assets, suffer food insecurity, and lose schooling for children.

Why?

Restrictions to contain COVID-19 are constraining economic activity. Testing-tracing-isolation, a successful strategy in 2020, has been less effective against the more infectious Delta variant. Vaccinations, which would have helped reduce mortality and transmission, have been slow. Therefore, governments have been forced to impose restrictions to stop the spread of the virus. In general, economic disruption has been less in countries with higher vaccination. A 10 percentage point higher vaccination coverage was associated with a one-half of a percentage point higher quarterly gross domestic product (GDP) growth.

Constraints on vaccination differ for countries in the region. Availability held back vaccination rates in larger countries like Indonesia, the Philippines, and Vietnam. Smaller, poorer countries, such as some of the Pacific islands, benefited from vaccine donations, but some are constrained by limited distribution infrastructure. In several countries, as vaccination levels increase, hesitancy is likely to be a constraint.

Two factors have softened the consequences of the present outbreak. First, domestic economic activity has so far been less sensitive to infections. One additional case per one thousand reduced industrial production by an average of

5 percent in May 2020 but had a negligible effect in June 2021. Second, the buoyant external environment has helped to sustain regional exports. In August 2021, China's merchandise exports increased by 31 percent in value terms over 2019-Q4 and those of other EAP countries by 21 percent.

But goods trade conditions are changing, and exports of tourism services will recover only slowly. Global goods import demand peaked in 2020-Q2, and regional exports face stronger competition as other regions recover. Commodity prices have stopped increasing. The Delta variant is disrupting production at home and in source countries, leading to shortages as well as increased shipping times and costs. The Delta variant has set back the recovery of tourism in the region.

The prolonged economic distress is straining the capacity of governments to provide economic support. As intertemporal budget constraints begin to bite, fiscal support across the region declined from an average of 7.7 percent in 2020 to 4.9 percent in 2021, even though economies are still operating below their potential. In contrast, as consumer price increases remain within central bank targets in most countries, monetary policy remains supportive and interest rates have not been increased, unlike in some other emerging markets. Despite increases in loans at risk, most countries other than China have not yet tightened financial sector regulations or rolled back regulatory forbearance.

The Near-Term Economic Risks

COVID-19 could hit all countries in the region even harder. Continued deficiencies in vaccination and limited testing could lead to recurrent waves of infections, possibly driven by new variants of concern, while health systems remain unprepared to deal with long COVID.

The region has less to fear from inflation at home than inflationary pressures abroad. Domestic inflationary pressures are low, except in Mongolia and the Philippines, because expectations are well anchored. But faster recovery and inflation in industrial countries could induce higher interest rates there, and premature financial tightening in the lagging EAP region.

Macro-financial risks are rising, and caution is warranted. The accumulation of record levels of debt by firms and households and of nonperforming loans by banks are a source of concern. All countries in the region have adequately capitalized banks but regulatory forbearance could hide deeper financial sector problems. The highly leveraged corporate sector, with strong links to the nonbank financial institutions, also poses a risk to financial stability. The extent of these risks has been revealed by the difficulties of certain firms in China, one of the first countries to roll back regulatory forbearance measures and resume efforts to contain financial risks associated with the highly leveraged real estate sector. Firms in other countries are also facing difficulties: between June and August 2020, almost one-half the businesses in Vietnam and more than 70 percent of businesses in Mongolia were in arrears or anticipating entering arrears within six months.

Policies for Recovery

Containing COVID-19

Current trends in vaccination could help the EAP transition to a relatively benign phase of COVID-19 by June 2022. Countries with vaccination rates higher than 60 percent, like Germany, Israel, and the United Kingdom, have reduced serious illness and mortality. Across EAP countries, vaccination rates are picking up: the share of the population that received at least one dose was an average of 18 percent by the end of June 2021 but had increased to 35 percent by the end of August 2021. Many EAP economies could reach 60 percent vaccine coverage by the first half of next year. A 60 percent coverage would not eliminate infections or the generation of new variants and countries will need to seek to achieve higher coverage. But the experience of countries with high vaccination rates reveals that it would significantly reduce the incidence of serious illness, hospitalization and mortality, allowing for a resumption of economic activity.

EAP countries must take other measures to contain COVID-19. Testing, tracing and isolation must be used to contain the spread of infections, as Singapore is doing. Precautionary behavior, such as some levels of social distancing and masks in crowded spaces, will also need to continue. Otherwise, new variants can lead to increased levels of infection and hence mortality, as Delta is doing. Health systems must be strengthened to deal with the lingering presence of COVID-19. And production of vaccines, including regionally, must expand to cope with sustained high demand and unreliable imported supply.

Macro-financial support

Domestic and international policy action can help governments extend fiscal support without undermining fiscal stability. Domestically, countries can (re-)introduce fiscal rules—as Indonesia and Malaysia are planning to do—as a commitment to limiting future deficits and debt; and enact legislation that commits to deeper reforms of both expenditure and revenue. Internationally, countries can coordinate fiscal stimulus and deepen cooperation on taxation to enable domestic revenue mobilization in the face of mobile capital.

Many EAP countries can use monetary policy space to support economic recovery in the near term but must remain alert to the risk of abrupt global financial tightening. Boosting the independence and credibility of central banks will help anchor inflationary expectations. More flexible exchange rate regimes would allow greater monetary policy autonomy and relieve pressures on reserves, for example, in the Lao People's Democratic Republic (PDR) and Myanmar.

Allowing easier access to credit must guard against potential financial instability. Current forbearance measures coexist with record accumulation of private sector debt in several jurisdictions, such as China, Malaysia, Thailand, and Vietnam. Such measures should be accompanied by greater transparency to help assess asset quality and the scale of nonperforming loans. Forbearance measures need to be gradually unwound in a coordinated and transparent manner to avoid destabilizing markets. Countries across the region need to strengthen their insolvency frameworks to facilitate firm exit and debt resolution.

Harnessing international integration

Open trade policies are more likely to support global economic recovery. Onshoring policies by industrial countries may "bring value chains home" but would reduce real incomes in the EAP region by 3 percent relative to the baseline in 2030, with trade-dependent Vietnam worst affected. Responding by liberalizing and facilitating trade, rather than through retaliatory restrictions, could lead to a net increase in real incomes for most countries, including in the EAP, and contribute to recovery.

FDI reforms too can boost growth. The recent investment reform in Indonesia could increase the annual GDP growth rate by as much as 0.2 percentage points. China, Malaysia, Thailand, and Vietnam could further reform their regimes for investment in the services sectors.

Bilateral and regional cooperation can facilitate international mobility of tourists and temporary workers. The Pacific Islands could develop a mutually recognized digital "vaccine passport," as well as credible testing certificates, with some of the countries which are major sources for tourists and destinations for temporary workers.

The Longer-Term Economic Risks

COVID-19 threatens to create a combination of slow growth and increasing inequality for the first time this century in the EAP. The result could be deprivation to an extent that the region has not seen in the last two decades. In Indonesia and the Philippines, as many as 8 million more people would remain trapped in poverty in 2023 if recovery is not accompanied by inequality reducing policies.

The adverse effects of the pandemic are likely to dampen long-term economic growth. In Indonesia, Mongolia, and the Philippines, firms lost on average at least 40 percent of their typical monthly sales and cut jobs. The failure of otherwise viable firms is leading to the loss of valuable intangible assets, such as supplier or customer relationships and know-how. Surviving firms are deferring productive investments. Unemployment can erode human capital and hurt future earnings. These negative effects on growth are likely to be stronger than any benefits of creative destruction induced by the crisis.

Increased inequality between firms could increase inequality between workers. Large firms' sales were only 15 percent lower by Winter 2020 than the year before, compared to 48 percent lower for micro firms; were more likely to adopt sophisticated technologies; and were more likely to receive government support. Workers of shrinking firms suffer because they cannot move easily between firms and locations, and the destinies of the poor are tied to family-run microbusinesses.

Increased inequality among households today can worsen inequality tomorrow. Income shocks among the poor have adverse long-term consequences. The distress selling of productive assets and increased debt can hurt longer-term incomes. Food insecurity increases the risk of stunting, which impedes children's development and earnings as adults. Limited engagement in online learning could cost the average student in school today a reduction of 3.8 percent in expected earnings every year.

As shown in the report, fiscal policy has not traditionally played a significant redistributive role in EAP, but social protection has stepped into the breach. The systems of direct taxes and transfers in developing East Asia neither worsen nor mitigate inequality, except in Mongolia. In 2020, a scaling up of cash transfers helped protect millions of people from the worst economic effects of the pandemic but may fall short of needs in 2021 in Myanmar, the Philippines, and Timor-Leste.

Policies to Promote Equitable Growth

Supporting firms

COVID-19 is also creating opportunities. The opportunity is primarily arising from the rapid diffusion of technology, which could boost productivity, improve learning, and transform state institutions. But harnessing technology will require policy reform.

Policies should support firms but not inhibit entry and exit. Extending support to productive firms must be accompanied by facilitating entry of new innovative firms through reforms of the business environment and allowing exit of weak firms through better bankruptcy laws and resolution frameworks. Services sector reforms will help finance, communication, transport, and other services be more effective. Countries must reduce remaining barriers to trade in both goods and services and strengthen procompetitive regulation.

Policies are needed to support broader technology diffusion. Equipping firms with the skills to embed technology in their business must be complemented with openness and competition policies to increase the incentives for firms to exploit such technologies. While digital infrastructure for basic technologies is often available, broadband access needs to be widened to facilitate the use that more advanced technologies requires.

Ensuring inclusion

Build adaptive social protection systems. Social protection in the region is still characterized by significant coverage gaps. These can be remedied by expanding eligibility for need-based assistance to the uncovered poor, increasing coverage of social insurance, and moving from the traditional static to dynamic targeting methods that can quickly capture those affected by shocks.

Education reform will help build stronger, more equitable human capital, taking advantage of new technological opportunities. Many countries in the region already faced learning crises with poor educational outcomes pre-COVID-19. Schools need to be reopened safely, with more individualized remedial support provided to recover learning losses. To build human capital to meet tomorrow's demands, reforms of teacher preparation, curricula, and teaching materials will need to complement investments in EdTech.

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