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Constrained Recovery: Global Shocks and Emerging Southeast Asia

DATA SNAPSHOT

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May 2024

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Cover image: Lights of Traffic — Bangkok, Thailand, 2018 (Aaron Thomas/Unsplash)

This report is produced by the Lowy Institute's Indo-Pacific Development Centre, which receives financial support from the Australian Department of Foreign Affairs and Trade.

Published 31 May 2024

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Version 2024-05-30.

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Introduction

Southeast Asia's emerging economies are some of the most successful in the world. Economic recovery from the Covid-19 pandemic and Russia's invasion of Ukraine is underway, and the region has returned to relatively strong growth. Nonetheless, the impact from these shocks and ongoing developments in the world economy has been substantial. This report focuses on how the high-performing economies of Emerging Southeast Asia — Cambodia, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam — have been affected and their outlook for growth and development reshaped by the tumultuous events of recent years.

Key findings

- Emerging Southeast Asia managed the economic impacts of Covid-19 and Russia's invasion of Ukraine relatively well. Nonetheless, the costs have been high in terms of foregone growth, weakened investment, sharp learning losses, slower poverty reduction, and constrained policy space due to large budget deficits and still elevated inflation.

- A tepid global recovery and high exposure to a weakened Chinese economy present substantial headwinds. Meanwhile, gains from the expected diversification of trade and investment out of China have so far been limited, reflecting China's continued dominance within manufacturing supply chains and tight global financial conditions.

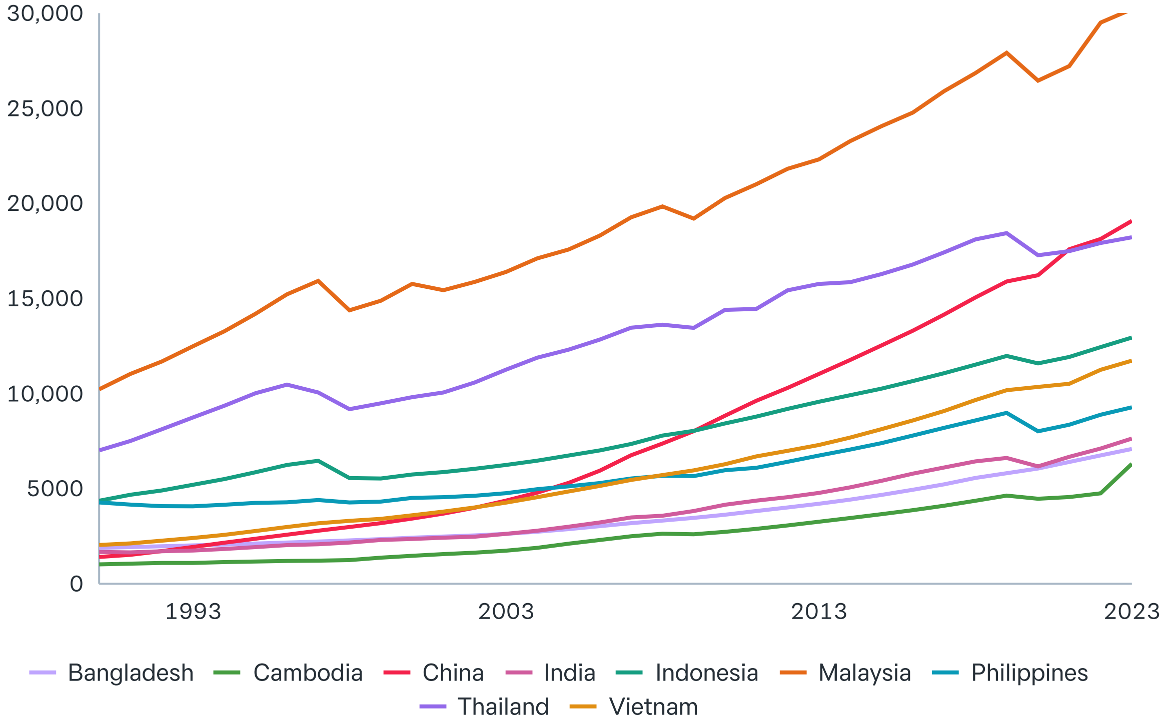
- The immediate policy challenge is to address the economic and social scars of the pandemic while maintaining a credible and sustainable macroeconomic framework. Generating more tax revenue is a key medium-term priority. Traditional competitiveness reforms coupled with a focus on meeting new priorities, such as the need for clean energy, would help capitalise on the opportunities from shifting international trade and investment.

Lost growth

Emerging Southeast Asia is poised to remain one of the best performing regions in the world.

Emerging Southeast Asia has returned to strong growth, rebounding from the global shocks of the Covid-19 pandemic and an inflation surge after Russia's invasion of Ukraine. Every country in the region except Thailand has seen per capita income levels rebound above their 2019 levels. Overall, the region seems poised to retain its position as one of the best-performing regional economies in the world. Before the pandemic, economic growth in Emerging Southeast Asia was robust at about 5.2% a year, behind only South Asia and China. Given income per person is much higher in Emerging Southeast Asia than in South Asia, this implies Emerging Southeast Asia's economic performance is arguably more impressive in terms of rising living standards.

Real GDP per capita, PPP constant 2017 international $

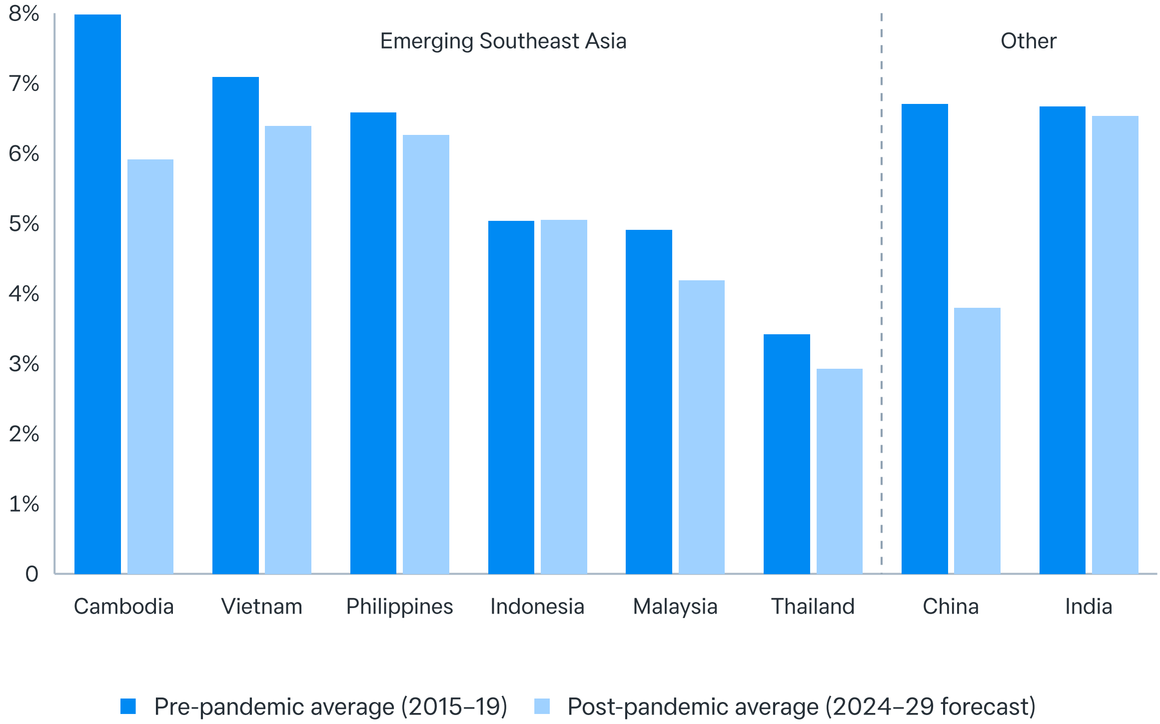


Source: IMF World Economic Outlook Database (April 2024)

The region nonetheless faces a diminished growth outlook, though it is now expected to outperform China.

Despite the return to strong growth, Emerging Southeast Asia's post-Covid outlook has been more negatively affected than most developing regions. Only in Indonesia – the region's largest economy – is growth expected to remain similar to its pre-Covid trend. Elsewhere, growth is expected to be materially slower. Most concerning is Cambodia, the least developed economy in Emerging Southeast Asia, which is forecast to see average growth decline from roughly 8 per cent before Covid to 5.9 per cent after. By contrast, growth is expected to be faster than before the pandemic in Latin America and the Caribbean, the Middle East and Central Asia, and Sub-Saharan Africa. Only in South Asia is post-Covid growth also expected to be slower but the slowdown is less severe that in Emerging Southeast Asia. Despite this, Emerging Southeast Asia is still growing faster than most of the rest of the world but its growth advantage seems to have shrunk since the pandemic.

Real GDP growth rates

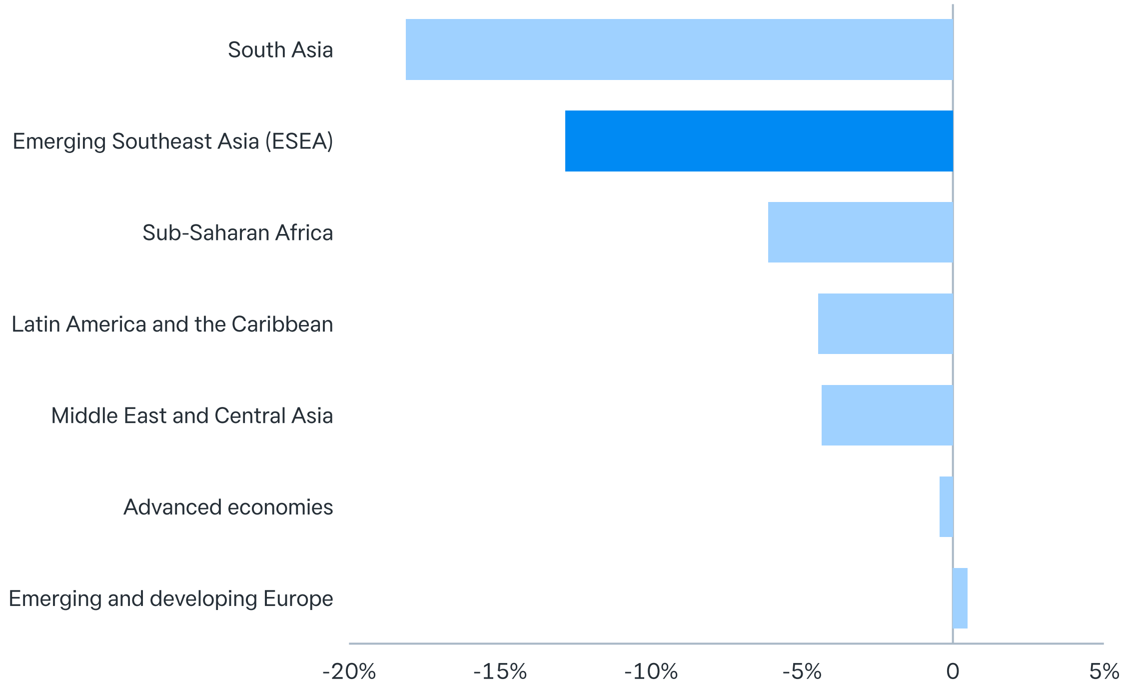


Source: IMF World Economic Outlook Database (April 2024), authors' calculations

The region has suffered some of the largest costs in foregone economic progress.

Emerging Southeast Asia's generally high growth rates imply recent global shocks have cost the region more than elsewhere in terms of lost growth and missed gains in living standards. Emerging Southeast Asia's collective GDP is 12.8% smaller today than what was expected prior to Covid. This is a far larger gap than any developing region except South Asia and dwarfs the 0.5% gap for advanced economies. The missed gains in living standards are similarly substantial, with GDP per capita in Emerging Southeast Asia 11.2% smaller than expected before the pandemic. Crucially, these losses are expected to be permanent given growth is projected to be slower than before the pandemic.

Lost real GDP, 2024 level compared to pre-Covid forecasts

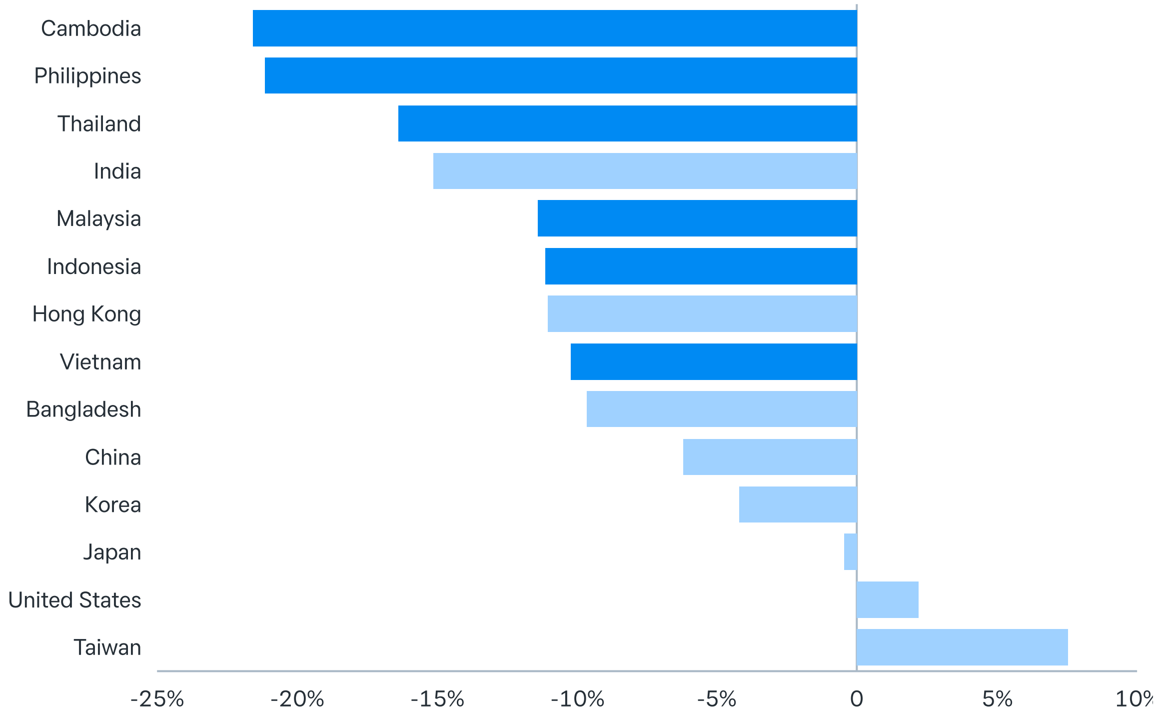


Source: IMF World Economic Outlook Database (October 2019 and April 2024), Sri Lanka First Review Under the Extended Fund Facility Arrangement: Selected Economic Indicators 2020-2028, authors' calculations

Cambodia, the Philippines, and Thailand suffered especially large economic losses.

The economies of Cambodia and the Philippines are more than 20% smaller than what was forecast before Covid. Thailand's economy is about 16% smaller. Only India has seen a comparable degree of foregone growth. In terms of living standards, Emerging Southeast Asia's per capita income losses compare even worse — with Cambodia, the Philippines, and Thailand having suffered the worst per capita income losses among major Asian economies, while Vietnam and Indonesia also compare poorly. Only Malaysia experienced relatively smaller losses to per capita income levels, reflecting lower population growth due to reduced inward migration of foreign workers during the pandemic.

Lost real GDP, 2024 level compared to pre-Covid forecasts

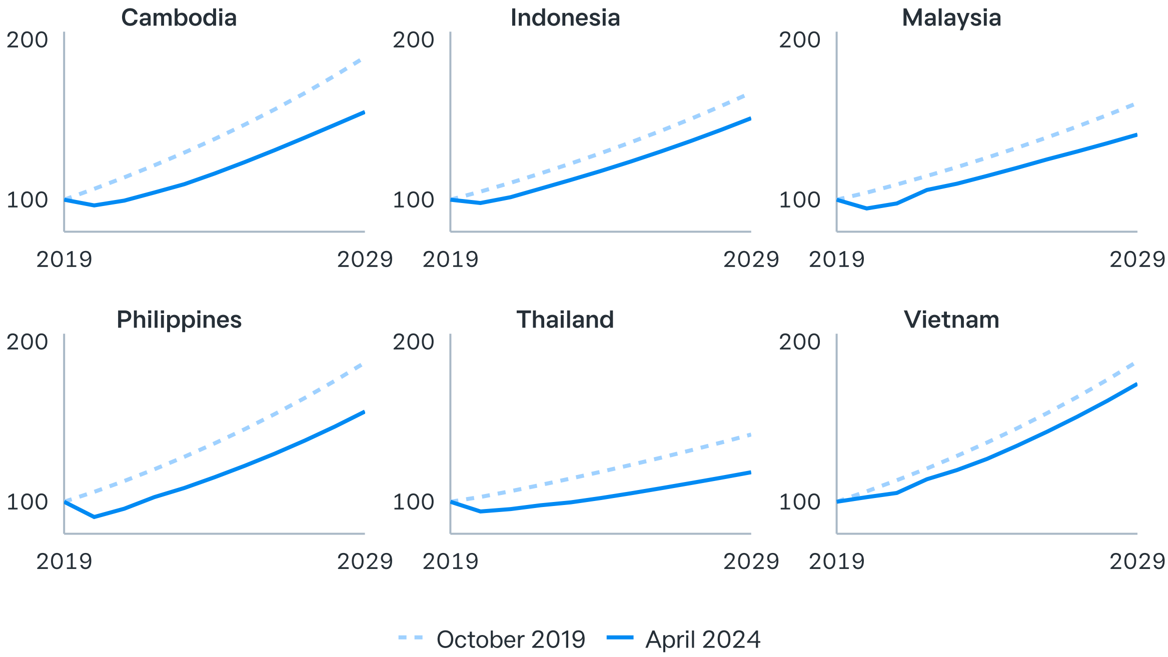


Source: IMF World Economic Outlook Database (October 2019 and April 2024), authors' calculations

Cambodia, Malaysia, and Thailand's growth trajectories have seen the worst impacts.

Cambodia not only saw substantial lost output, but future growth is forecast to be considerably slower. The country appears to have shifted onto a lower overall post-Covid growth trajectory, with high growth prior to the pandemic driven by unsustainable factors including a real estate and construction boom. Malaysia and Thailand have also seen material downward shifts in medium-term growth prospects, while growth in Vietnam and the Philippines is expected to be modestly slower than before the pandemic. Only Indonesia's growth is expected to return to its pre-pandemic trend of about 5%. These downgraded growth trajectories are being driven by compounding factors including economic and social scarring from the pandemic, elevated inflation and interest rates, weakening global trade, and a slowing Chinese economy.

Real GDP trajectories before and after Covid, 2019 = 100



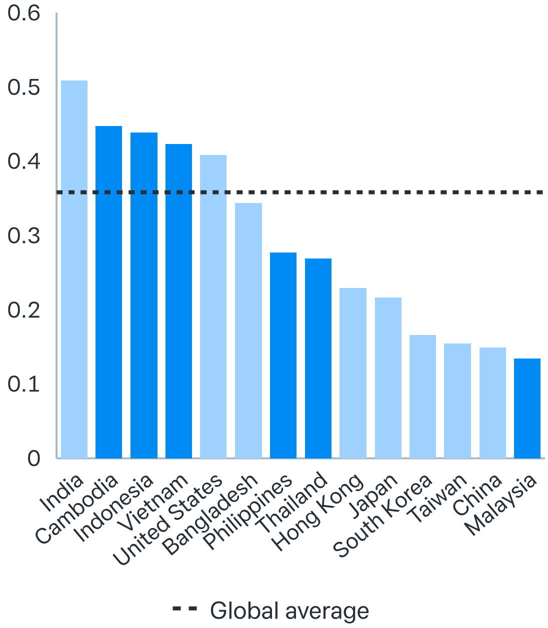
Source: IMF WEO October 2019 and April 2024 databases, authors' calculations

Managing global shocks

Emerging Southeast Asia's handling of the pandemic was mixed but broadly comparable to peers.

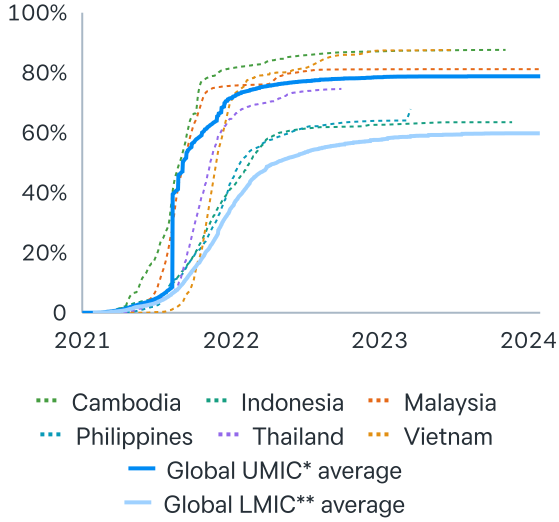
Data on "excess deaths" per capita (the total number of deaths above and beyond what would have been expected based on pre-pandemic trends) provides a useful measure of how well countries handled the health impacts of the pandemic. Malaysia stands out as having been highly effective, with excess deaths per capita close to other strong performers such as China, South Korea, and Taiwan. The rest of the region performed more poorly, with excess deaths per capita above the global average in Cambodia, Indonesia, and Vietnam. In terms of getting populations vaccinated, the region did reasonably well. Vaccines were critical to reducing the health impacts of the pandemic and enabling economic recovery. After an initial delay in accessing vaccines, vaccination rates in the region soared through 2021, with the majority of the population receiving shots before 2022 — comparing favourably to most other middle-income countries.

Cumulative excess deaths



Source: Our World in Data, United Nations Population Division, authors' calculations

Population fully vaccinated per capita 2020–23



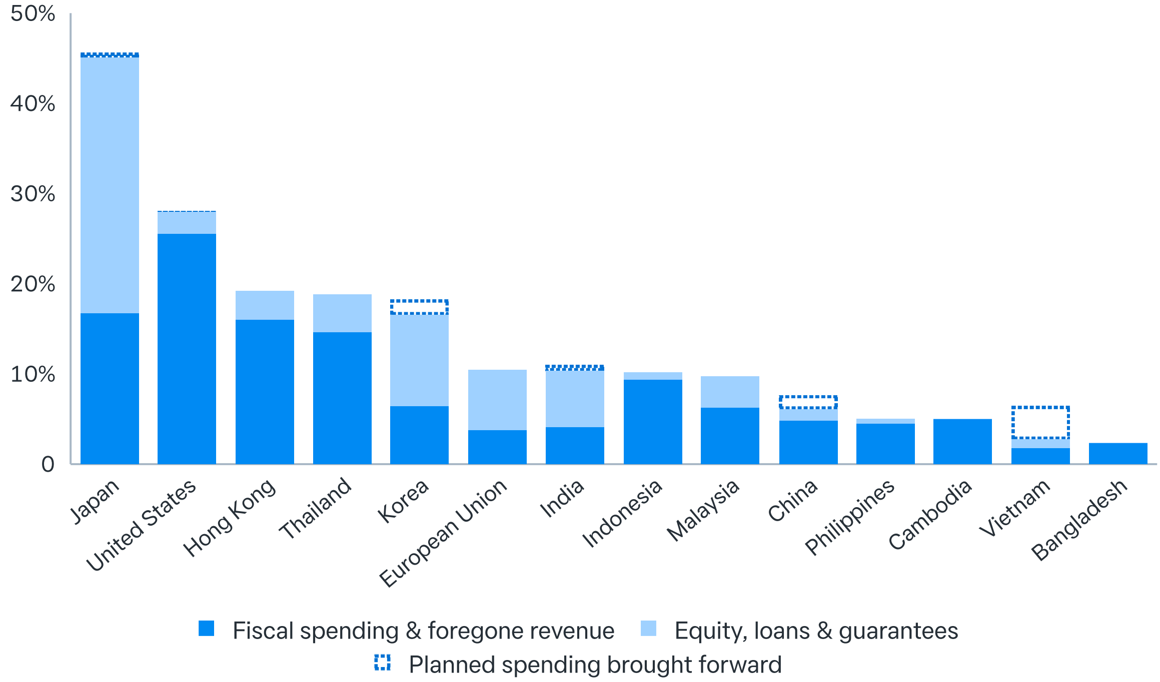
Source: Our World in Data, authors' calculations

* Upper middle income countries ** Lower middle income countries

Macroeconomic policymakers responded to the pandemic with forceful policy responses.

Fiscal support packages were critical to limiting the economic and social fallout from the pandemic and enabling the subsequent recovery. Cumulative fiscal packages in the region were forceful during 2020–21 and ranged from 5% of GDP in Cambodia and Vietnam to 9% of GDP in Indonesia. Only Thailand responded with a fiscal package on a similar scale to advanced economies, at almost 20% of GDP. Given the nature of the crisis, interest rate cuts played a secondary role with a focus on supporting financial stability. However, with global capital markets in freefall and liquidity drying up, central banks in Indonesia and the Philippines also deployed unconventional monetary policy, financing government fiscal operations through the large-scale purchase of sovereign bonds. Central banks in Malaysia and Thailand also expanded their balance sheets, though not to the same extent.

Size of fiscal response to Covid, % of nominal GDP



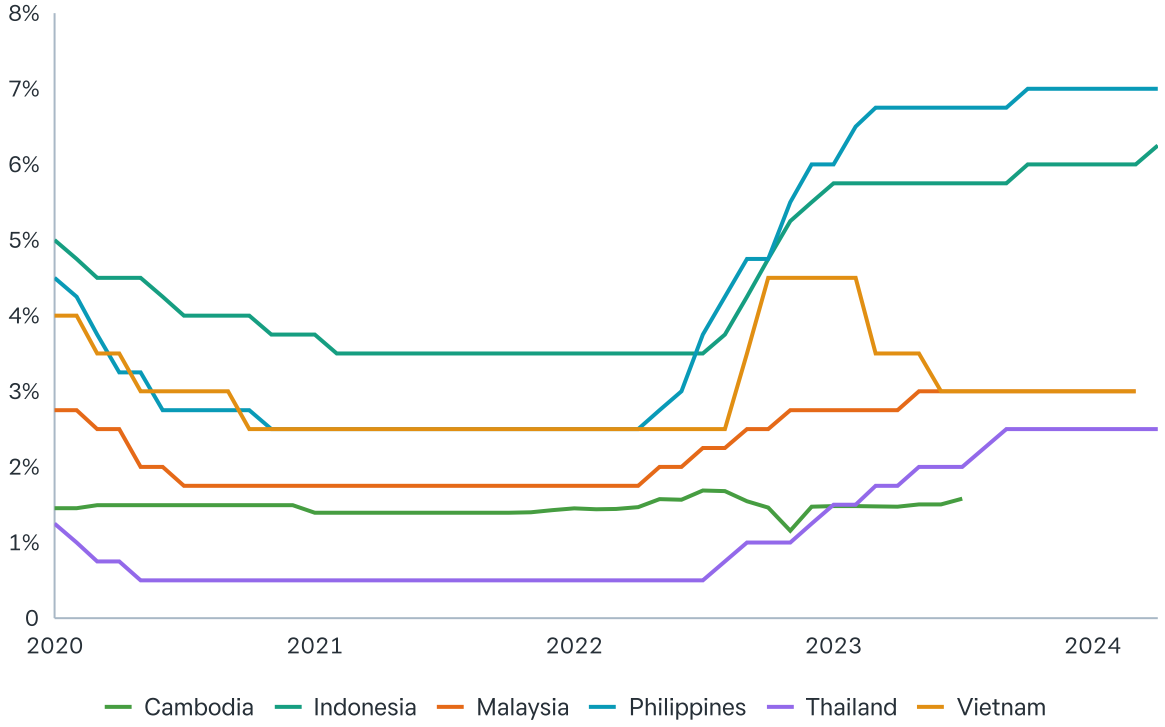
Source: IMF Database of Country Fiscal Measures in Response to the Covid-19 Pandemic

Note: Data is until September 2021 and includes both announced and disbursed amounts by governments

The region effectively weathered the economic spillovers from Russia's invasion of Ukraine.

Emerging Southeast Asia's direct economic exposures to both Russia and Ukraine are limited. However, steep rises in inflation, global interest rates, and commodity prices weighed on investment, exports, and real household incomes. Higher commodity prices, however, boosted net exports in Indonesia and Malaysia as major producers of coal, gas, oil, and palm oil. Central banks in the region hiked interest rates by less than in the United States, placing a greater emphasis on supporting economic recovery over taming inflation. The exception was the Philippines, which saw the highest inflation and interest rates in the region. Critically, despite initial concerns, Emerging Southeast Asia managed the financial pressures from rising global interest rates well — largely avoiding excessive capital outflows, currency depreciation, or spikes in sovereign bond yields.

Interest rates set by central banks



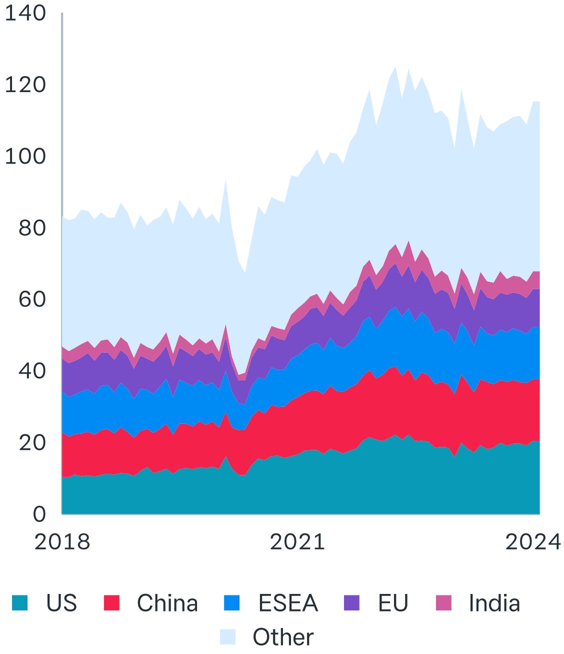
Source: CEIC

China's slowdown

Softening exports and a weakened Chinese economy weigh on the economic outlook.

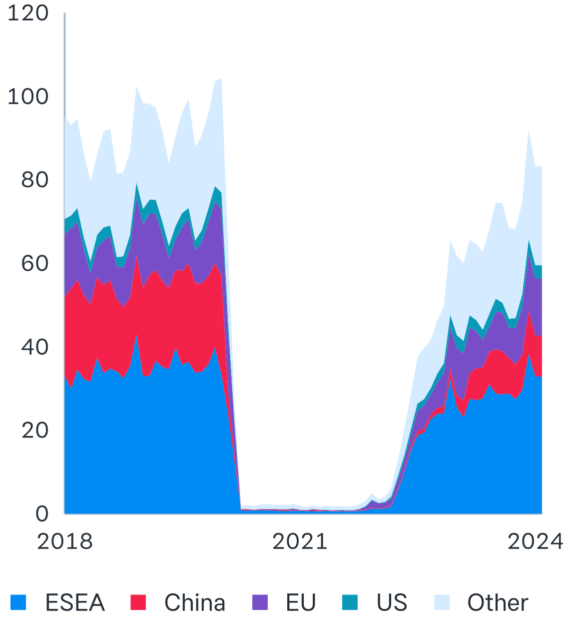
Emerging Southeast Asia's exports boomed during the pandemic along with most of the world, providing a key source of economic growth. However, a slowing global economy has turned export growth from tailwind to headwind. High exposure to a weakened Chinese economy is weighing especially heavily on the region's merchandise exports, given China is a critical export market for most Emerging Southeast Asian countries. China's economic problems are also affecting the recovery in tourism, particularly for Cambodia and Thailand where tourism is an important sector and China was the largest single source of visitors before the pandemic.

Goods exports by destination, US$ bn



Source: CEIC, authors' calculations

Number of tourist arrivals, million people

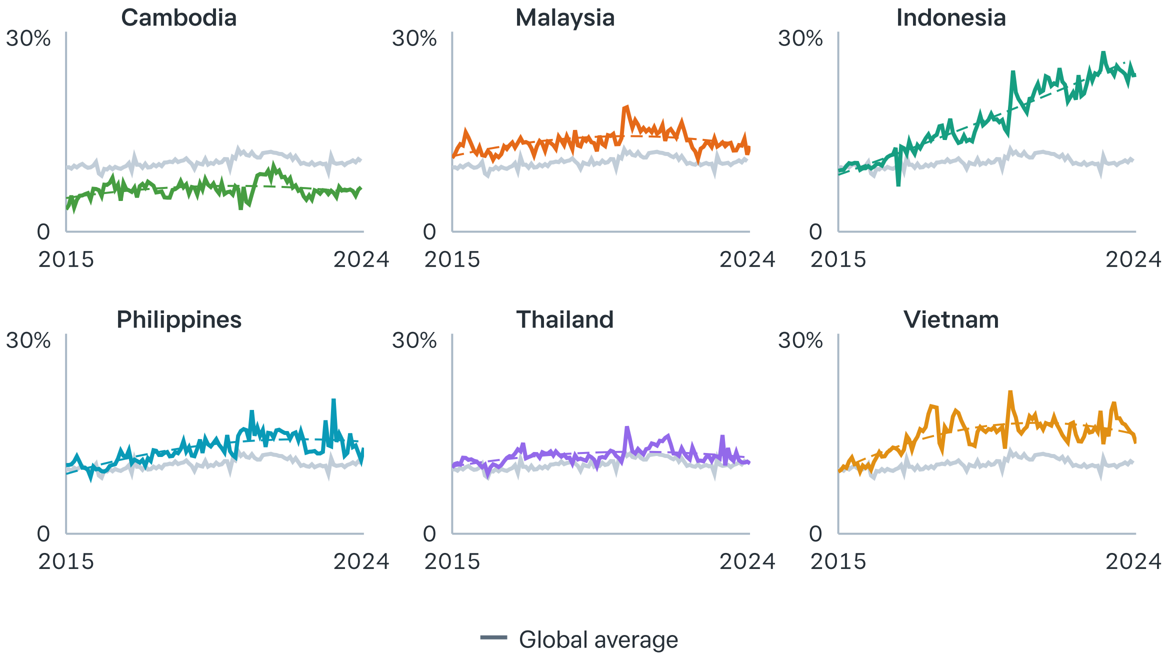


Source: CEIC, authors' calculations

China's prominence as an export market has plateaued in most of the region.

Strong growth in China's economy before the pandemic was increasingly drawing Emerging Southeast Asia into China's trade orbit. However, the pandemic, growing geopolitical tensions, and a slowing Chinese economy have ended this trend, at least for now. The exception is Indonesia, where China has rapidly become a critical destination for the country's exports. Since 2020, coal and metals exports rose to meet growing demand driven by China's large manufacturing and infrastructure-led stimulus and its trade restrictions on Australian coal. China's importance as an export market for the region overall, however, has not declined meaningfully, and the region's exports are still more dependent on China than the global average. The exception is Cambodia, where the United States and Europe are the major export markets.

Share of total goods exports going to China



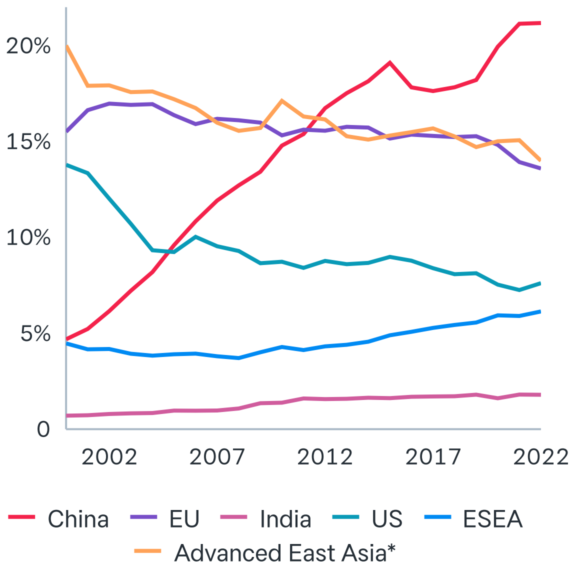
Source: CEIC, authors' calculations Note: Dotted lines show trend

Diversification and investment

Benefits from the diversification of global supply chains away from China have so far been limited.

Emerging Southeast Asian economies are expected to be among the prime beneficiaries of the diversification of global supply chains away from China. Thus far, however, the benefits for the region have been limited. Although Emerging Southeast Asia has increased its global share of manufacturing exports, this has been swamped by the renewed surge in China's exports during the pandemic. Moreover, the region's manufacturing exports contain a rising share of intermediate inputs from China, dramatically so in the case of Cambodia. That is, although the region is exporting a greater share of the world's manufactures, much of the value is coming from China in the form of parts and components as well as transhipment of finished or near-finished products. Indeed, with the exception of Vietnam, the domestic value-added content of the region's exports has not increased materially relative to GDP over the last decade – indicating that stronger exports are not necessarily supporting faster economic growth.

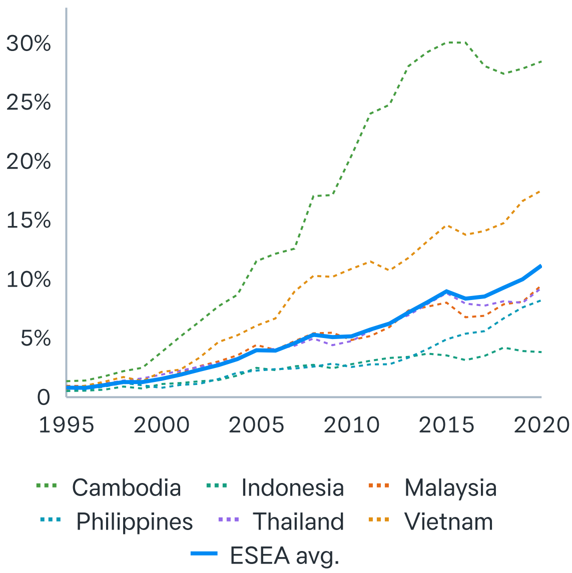
Share of global manufacturing exports



Source: WTO, authors' calculations

* Advanced East Asia includes Hong Kong, Japan, South Korea and Taiwan

China's hidden value-add share within gross manufacturing exports

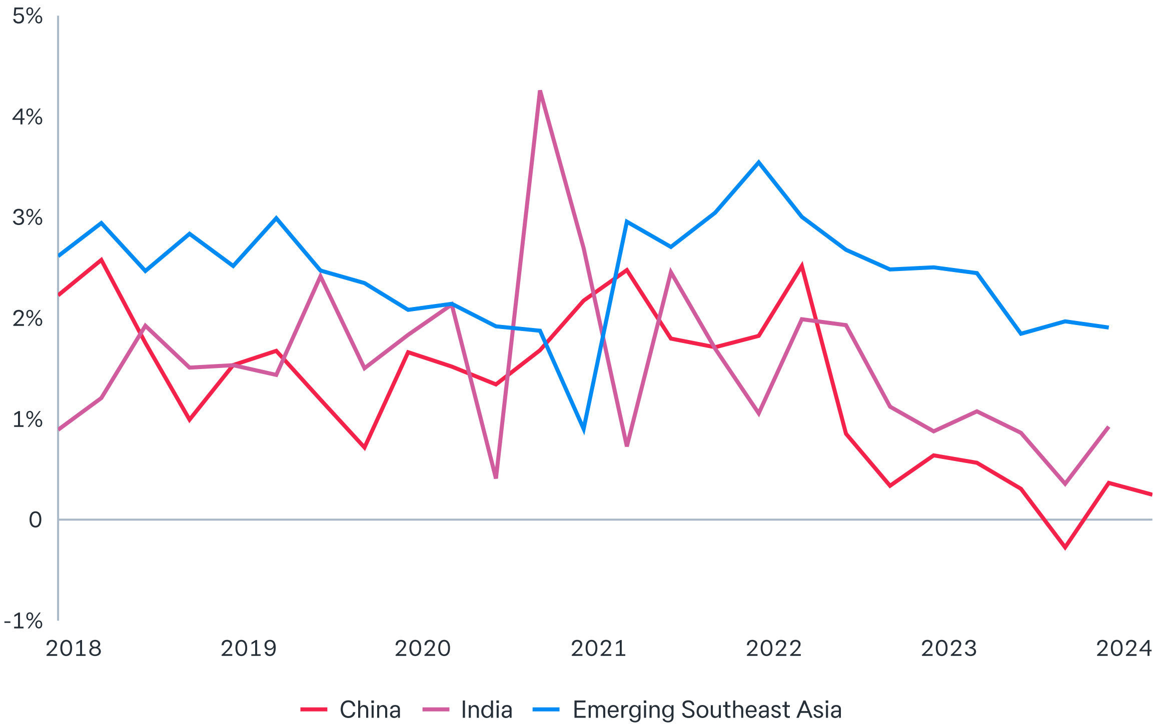


Source: OECD Trade in Value-Add Database (2023 edition), authors' calculations

The region has become a preferred investment destination but total inflows are in decline.

Emerging Southeast Asia's attractiveness as a destination for foreign direct investment (FDI) appears to be on the rise as global supply chains seek to reconfigure and China's economy continues to weaken. However, despite numerous signs of FDI reorienting towards the region, the benefits again appear to have proven relatively limited thus far. FDI inflows to Emerging Southeast Asia have fallen in recent years relative to the region's GDP, with the ratio now lower than it was before the pandemic. This aligns with the global picture of reduced FDI inflows given tightening global financial conditions in the face of inflation. The reduction in FDI to Emerging Southeast Asia has been less than has occurred in other major Asian economies, most notably China but also India. However, the region has not been able to capitalise in a substantial way on the dramatic reduction in FDI going into China. As it stands, the benefits to the region's growth prospects from the shift in global investment are yet to materialise in a significant way.

Net FDI inflows, % of nominal GDP



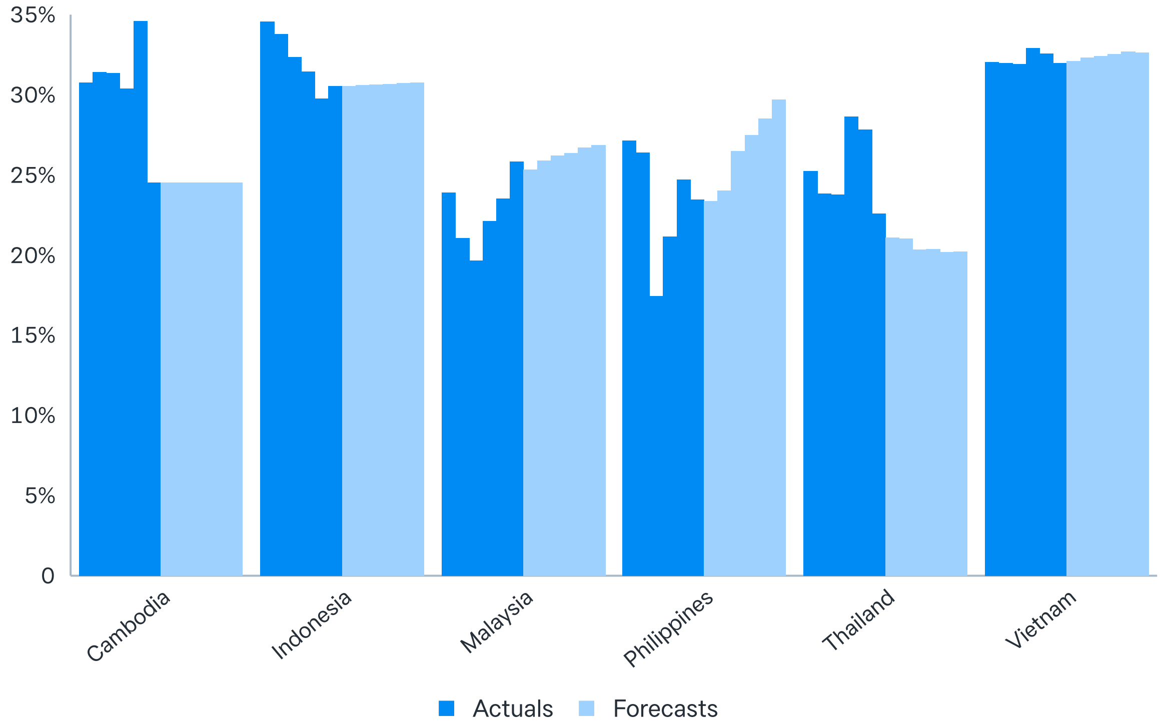
Source: CEIC, authors' calculations

Post-pandemic development

Domestic investment conditions have softened, pointing to slower future growth.

High investment rates have been critical to Emerging Southeast Asia's ability to sustain rapid economic growth. Every country saw investment levels relative to GDP fall during Covid. Now, with the exception of Malaysia and Vietnam, investment levels in the region are expected to soften over the next few years. This will weigh on the region's future growth prospects. Looking ahead, investment levels are projected by the International Monetary Fund (IMF) to meaningfully increase only in the Philippines over the next several years. Elevated private debt levels, rising non-performing loans, higher interest rates, and reduced credit availability are weighing on domestic investment environments across the region, and there is a real risk of a lost decade of investment.

Total investment 2018–29, % of nominal GDP

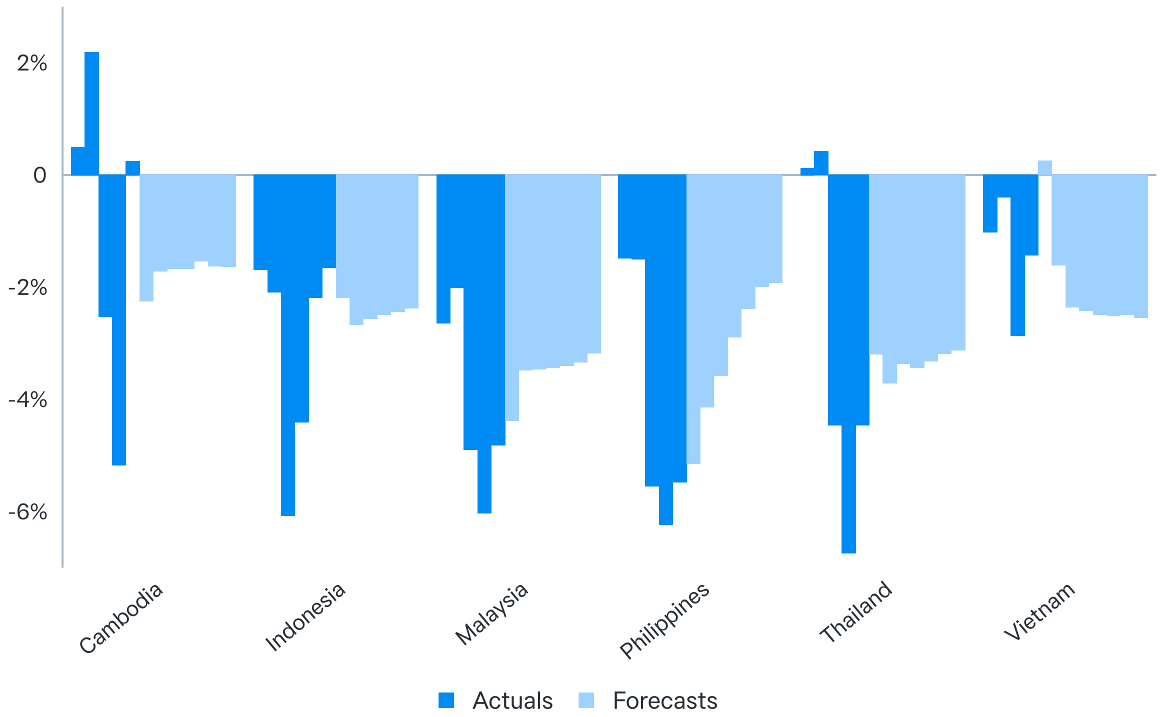


Source: IMF World Economic Outlook Database (April 2024)

Large and persistent budget deficits point to limited remaining fiscal space.

After responding forcefully to the pandemic with extraordinary fiscal packages, governments across the region have switched to reining in budget deficits, limiting their ability to support a stronger recovery. Despite this, large deficits are expected to persist, and the fiscal consolidation required to bring these back towards more sustainable levels and leave scope to respond to future shocks is substantial. Governments must also balance the desire for fiscal discipline with maintaining support for economic recovery given soft private sector activity and investment. Alleviating the negative impacts from recent shocks within the limited fiscal space available is one of the key policy challenges facing the region. Threading this needle will be difficult but necessary, as the negative impacts from pivoting to fiscal consolidation too early or strongly have the potential to be just as, if not more, detrimental to the region's economic prospects.

Fiscal balance 2018–29, % of GDP

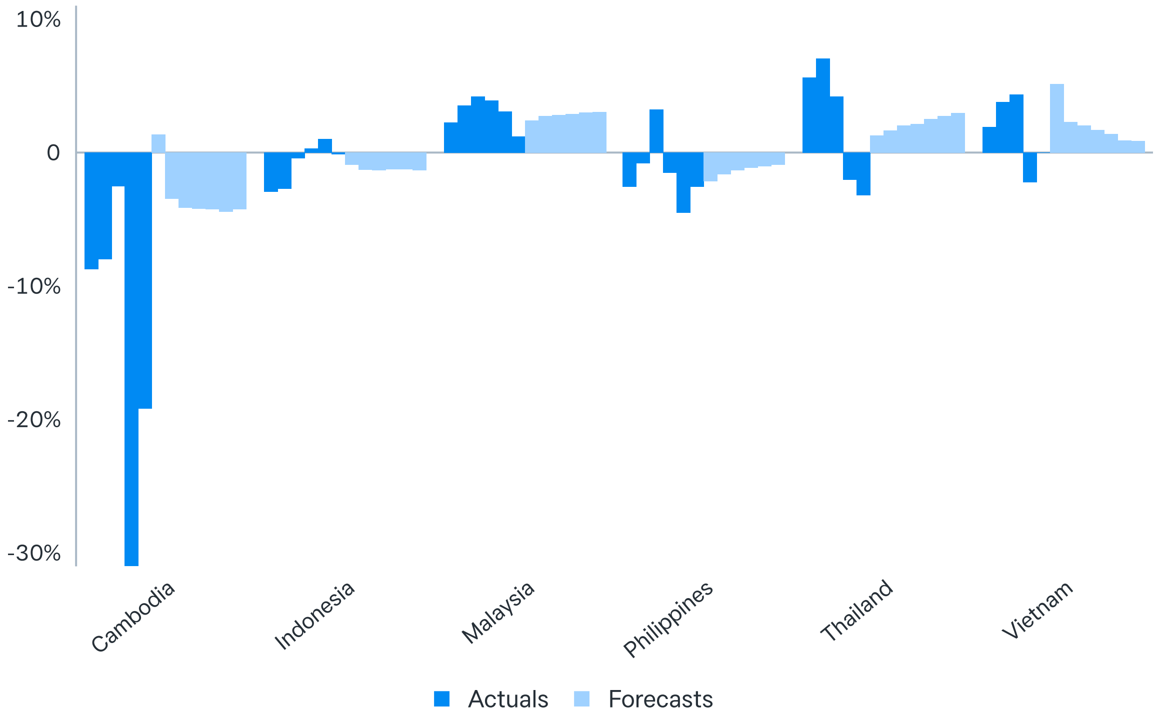


Source: IMF World Economic Outlook Database (April 2024)

External financing remains important for some countries in the region.

Current account balances have been volatile, reflecting the impacts of subdued domestic demand during Covid, the collapse of international tourism, commodity price shocks, and large swings in export revenue. Cambodia's current account deficit expanded dramatically during the pandemic but has since moderated. Indonesia and the Philippines are set to return to sustained current account deficits, albeit at modest levels. While not overly concerning, the presence of current account deficits in these countries increases their exposure to volatile financial markets, especially as their governments seek to finance ongoing budget deficits. Maintaining strong policy credibility and attracting greater FDI as a more stable and productive source of finance will have added priority for these countries.

Current account balance 2018–29, % of GDP

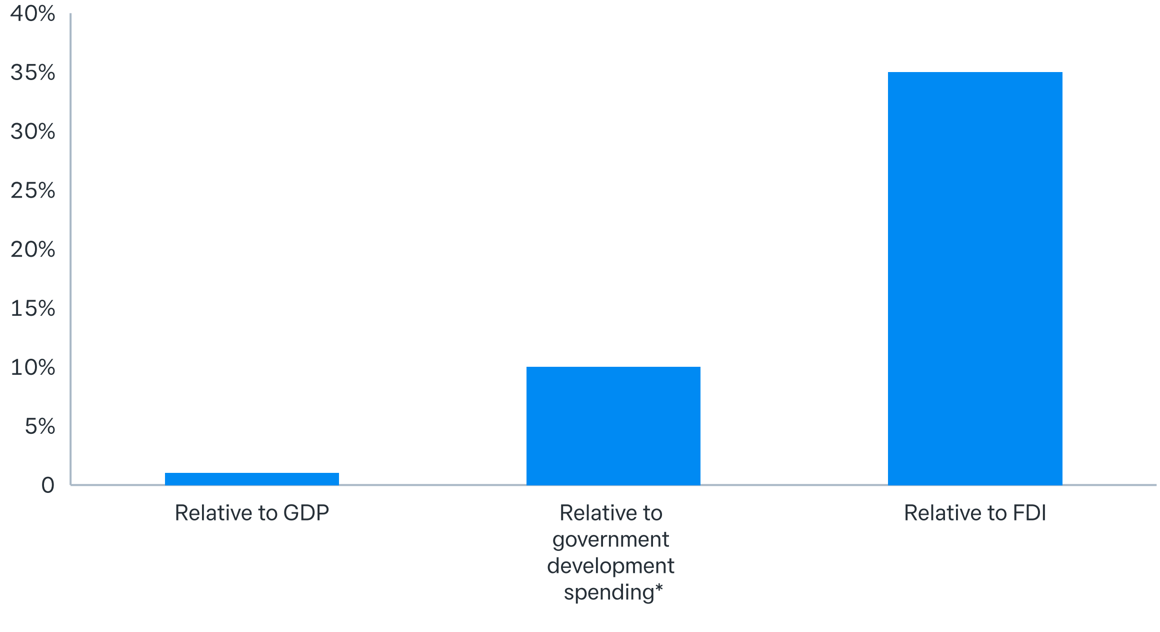


Source: IMF World Economic Outlook Database (April 2024)

Official development support has a major role to play but has been declining in recent years.

Though only accounting for about 1% of GDP in the region, official development finance has in recent years been equal to around 10% of all government spending on infrastructure, health, education, and social safety nets. It is also equivalent to a third of total FDI inflows. Development support plays an especially large role in Cambodia, the lowest-income Emerging Southeast Asian country, equivalent to 80% of public development spending. However, outside of the pandemic crisis years, total development support has been declining, especially from China, which until recently was the largest source of development financing. Given the importance of external support to financing key development priorities in the region, a continuation of this trend would bode ill for the region's recovery and future developmental progress.

Development finance relative to other measures, 2015–21



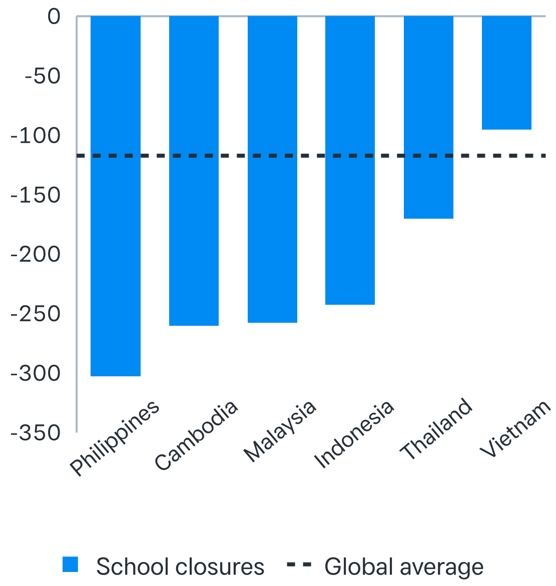
Source: Authors' calculations based on Lowy Institute Southeast Asia Aid Map, World Bank and IMF data

* Includes government spending on education, health, social protection, and infrastructure

Emerging Southeast Asia suffered especially sharp learning losses due to long school closures and digital inequality.

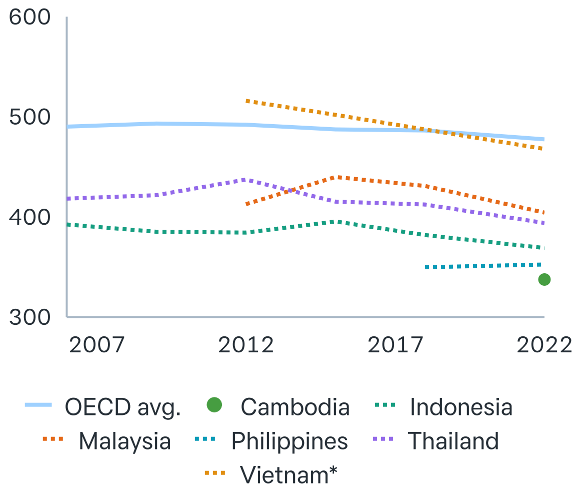
Improving education levels is critical to the region's long-term economic and social development hopes. Regrettably, Emerging Southeast Asia appears to have suffered especially acute educational setbacks due to the pandemic. School closures were longer than the global average, leading to much larger learning losses than the OECD average across mathematics, reading, and science. Sharp learning losses appear attributable to the combination of longer school closures (with the exception of Vietnam) and lower digital access, which restricted remote learning opportunities. Pre-pandemic education quality also mattered. Countries with a higher quality of education — including Vietnam, Malaysia, and Thailand — suffered larger losses, whereas those with a lower quality of schooling saw smaller losses or none at all. Notably, learning outcomes in Vietnam, the region's star performer, have now fallen behind the OECD average across all measured learning categories. If left unaddressed, education losses will impact future workforce productivity and lifetime earnings, dragging down long-term economic and social development prospects.

Number of days of school closures



Source: UNESCO Global Monitoring of School Closures Caused by the Covid-19 Pandemic database, authors' calculations

Average exam score across mathematics, reading, and science



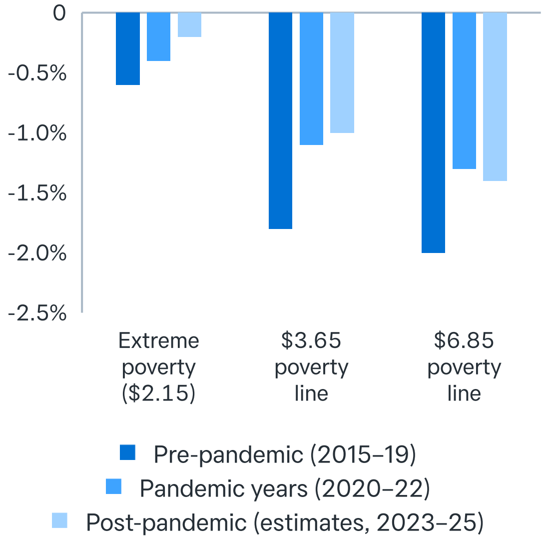
Source: OECD Programme for International Student Assessment database, authors' calculations

* Vietnam's change from pre-pandemic to post-pandemic score is 2015–22. Cambodia's first year of participation was in 2022

Progress in combating poverty is expected to be substantially slower in the aftermath of the pandemic.

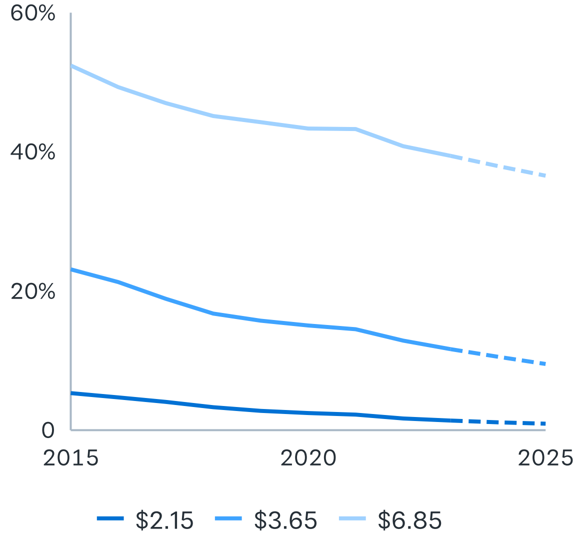
Emerging Southeast Asia has seen tremendous success in poverty reduction over many decades. The region managed to continue reducing poverty through the pandemic, and poverty reduction is expected to continue going forward, but at a much-reduced pace. Emerging Southeast Asia has almost eliminated extreme poverty (defined as living below US$2.15 a day), with the exception of Cambodia, for which up-to-date poverty data is unavailable. However, at slightly higher poverty lines relevant for middle-income countries, there is still much work to be done. In Indonesia and the Philippines, about 18% and 14% of people still live on less than US$3.65 per day. Poverty is much lower in Malaysia, Thailand, and Vietnam. However, a large share of the population in these countries (around 3%, 10%, and 16% respectively) still live on less than US$6.85 per day. Slower expected progress on combating poverty in part reflects greater difficulty in reaching the remaining poor. However, it also reflects expectations for slower economic growth and job creation as well as reduced fiscal resources available for poverty reduction programs.

Annual change in poverty rate in Emerging Southeast Asia, %



Source: World Bank Poverty and Inequality Platform, authors' calculations

Poverty rates in Emerging Southeast Asia, % of population



Source: World Bank Poverty and Inequality Platform, authors' calculations

Outlook and challenges

Emerging Southeast Asia has returned to strong economic growth, with the region quickly reclaiming its spot as one of the best-performing regions in the world.

However, after successive global shocks, economic and developmental progress has been set back and is now proceeding more slowly. Investment has softened and financial conditions remain tight. Poverty reduction has slowed and the region has suffered sharp learning losses. Policymakers meanwhile have limited space to manoeuvre given large budget deficits, elevated inflation, and persistent current account deficits forecast in several countries. Although the region's openness has been key to its success, this also creates higher exposure to softer global trade and a weakened Chinese economy. All of this coalesces into a diminished economic outlook for the region.

With policy space constrained, the challenge for governments is in addressing the scars of the pandemic while maintaining a credible and sustainable macro-economic framework. Targeted spending to reduce poverty and reverse educational losses is an immediate priority. In the medium term, a focus on raising greater tax revenues will be vital to allowing much-needed additional spending on core development priorities while protecting fiscal sustainability, noting that tax levels across the region are generally low.

Emerging Southeast Asia also has an important opportunity to generate faster growth by attracting investment and global supply chains as these increasingly shift away from China. So far, the benefits from this diversification have been limited. Capitalising on this will require traditional competitiveness reforms in areas such as infrastructure, skills, and the business-enabling environment, as well as next-generation reforms to meet the growing focus of trading partners and multinational firms on higher environmental, social, and governance standards, especially those related to the clean energy transition.

About the authors

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Robert Walker is a Research Associate at the Lowy Institute and works as an economist in the Institute's Indo-Pacific Development Centre. His work focuses on emerging Asian economies as well as growth and development in the Indo-Pacific region. Robert's interests include macroeconomic policy, aid and development, geoeconomics and Indo-Pacific and European international political economy. Prior to joining the Lowy Institute, Robert worked in the Australian Department of the Treasury in international macroeconomic forecasting and at the Australian National University's Australian Centre on China in the World. He holds a Master's degree in International and Development Economics from the Australian National University with a specialisation in macroeconomic policy, and a Bachelor of International and Global Studies from the University of Sydney.

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Roland Rajah is Director of the Indo-Pacific Development Centre, a dedicated policy research centre within the Lowy Institute. The Centre is committed to producing fresh policy insights and ideas on the most pressing economic development challenges facing the Indo-Pacific region — principally focusing on the emerging and developing economies of Southeast Asia, the Pacific Islands and South Asia. He also serves as the Lowy Institute's Lead Economist, a position he has held since joining the Institute in 2017. Roland directs the overall work program of the Indo-Pacific Development Centre across its key thematic pillars of post-Covid growth and development, globalisation and regional integration, climate change and development, technology and digital economy, aid and development finance, and geoeconomics.

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