

FROM CONTAINMENT TO RECOVERY



Overview

Successful containment: The pandemic has so far been contained in parts of the EAP region, but not in Indonesia and the Philippines, and is still a threat to other countries, most recently Myanmar. The countries that contained the disease used a *combination* of stringent mobility restrictions, extensive testing-based strategies, and information programs to encourage precautionary behavior.

Economic distress: The pandemic and efforts to contain its spread led to a significant curtailment of economic activity. These domestic difficulties were compounded by the pandemic-induced global recession which hit EAP economies that rely on trade and tourism hard. Country outcomes were generally related to how efficiently the disease was contained and how exposed countries were to external shocks. Output contracted by 1.8 percent in China in the first half of 2020 and by 4.0 percent on average in the rest of the region. The COVID-19 shock is expected to increase the number of people living in poverty in the region by 38 million in 2020—including 33 million who would have otherwise escaped poverty, and another 5 million who would be pushed back into poverty—using a poverty line of US\$5.50/day (2011 PPP).

Relief: In response, EAP governments have committed nearly 5 percent of GDP on average to support public health systems, help households to smooth consumption, and help firms to avoid bankruptcy. But since these countries previously spent less than 1 percent of their GDP on average on social assistance, scaling up and implementation have proved difficult. In several countries, assistance has so far reached less than 25 percent of households whose incomes fell and only 10–20 percent of eligible firms. Reaching workers and firms in the informal sector has been most difficult. Continuing support in a protracted crisis would strain the narrow revenue base of most EAP countries.

Mixed prospects for recovery: Successful containment of the disease in some countries is leading to a revival of domestic economic activity. But the EAP region's economy is heavily dependent on the rest of the world, and global demand remains subdued. Trade will see a revival as global economic activity gradually resumes, but tourism is unlikely to recover soon. Though short-term capital has returned to the region, global uncertainty still inhibits domestic and foreign investment. The capacity of financially strained governments to stimulate the economies is also limited. The region is forecast to grow by only 0.9 percent in 2020. Whereas China is forecast to grow by 2.0 percent—because it has kept new infections at a low rate since early March, prioritized the revival of production, and increased public investment—the rest of the EAP region is projected to contract by 3.5 percent on average in 2020. Prospects for the region are brighter in 2021, with growth expected to be 7.9 percent in China and 5.1 percent in the rest of the EAP region, based on the assumption of continued recovery in the region and normalization of activity in major economies, linked to the possible arrival of a vaccine. However, for all economies in the region, output is projected to remain well below pre-pandemic projections for the next two years. The outlook is particularly dire for some highly exposed Pacific Island countries where output is projected to remain about 10 percent below precrisis levels by late-2021.

Adverse impact on inclusive growth: COVID-19 will have a lasting impact on inclusive longer-term growth by hurting investment, human capital, and productivity. Public and private indebtedness, along with worsening bank balance sheets and increased uncertainty, are likely to inhibit public and private investment, as well as pose a risk to economic stability. Sickness, food insecurity, job losses, and school closures could lead to the erosion of human capital and earning losses that last a lifetime. Firm closures and disruption in firm-worker relationships could hurt productivity through a loss of valuable intangible assets. The disruption of trade and global value chains could hurt productivity by leading to a less efficient allocation of resources across sectors and firms, and by dampening the diffusion of technology. Left unremedied, these consequences of the pandemic could reduce regional growth over the next decade by 1 percentage point per year.

The poor will be disproportionately disempowered because of their lower level of access to hospitals, schools, jobs, and finance. The adverse effects on growth and distribution may be partially offset by the COVID-19-induced acceleration in digital technologies, which could boost productivity and improve access to services for the poor.

An integrated view of policy: Policy choices to contain disease surges and provide relief today would ideally be informed by how they will affect recovery and growth tomorrow. And policy choices in one area, say health, will have an impact on goals in other areas, like the economy. Governments face difficult trade-offs. Significant expenditure on relief or a consumption-supporting stimulus may leave an indebted government less equipped to invest in infrastructure, and hence growth. And how governments distribute the burden of public debt across individuals and over time—through indirect taxes, income and profit taxes, inflation, or financial repression—will matter for both growth and distribution. The crisis has shown that taking a dynamic view could help EAP governments make choices today that soften trade-offs tomorrow in seven key areas:

- **Building capacity for smart containment**—including to test, trace, and isolate—would help contain disease surges with more targeted and less economically disruptive measures. For example, preliminary analysis suggests that open public testing, including of asymptomatic people, could reduce the number of infections by 10 percent in a month. At the same time, cooperating internationally to incentivize the development of a vaccine and preparing to distribute it efficiently and fairly would contribute to social stability and facilitate economic recovery.
- **Initiating fiscal reforms** could allow greater spending on relief without sacrificing public investment. The budget constraint is difficult because revenue mobilization is exceptionally low in the EAP countries other than China—only 18 percent of GDP on average, compared to 25 percent in other developing economies and 36 percent in advanced economies. And the greater reliance on indirect taxes, which represent more than 50 percent of government revenue in several countries, has amplified the revenue loss in a crisis in which consumption has contracted sharply. Large fiscal deficits in EAP are projected to increase government debt on average by 7 percentage points of GDP in 2020. High and growing private debt constitutes an additional indirect risk for government finances. Widening the tax base with more progressive taxation of income and profits and less wasteful spending on regressive energy subsidies, in some cases over 2 percent of GDP, could make recovery more inclusive and sustainable.
- EAP governments will need to **maintain hard-won reputations for financial prudence** in the face of increasing financing needs. Even though EAP governments are largely financing deficits through domestic borrowing, some are also inducing central banks to buy sovereign bonds. Pursued beyond a point, such actions could undermine central bank independence and inflation control which have been crucial for macroeconomic stability in the region. Overreliance on the banking system as a conduit for extending support could also pose risks. The available data suggest that EAP banks are relatively well-capitalized, but nonperforming loans have increased despite relaxed prudential measures and permissive accounting rules. While these policies may be necessary today, credible commitments to transparency and to early restoration of financial discipline could help mitigate the risk of financial instability.
- Social protection has a triple role: mitigate the immediate impact of the crisis; help workers reintegrate as countries recover; and prevent long-term harm to human capital. **Widening social protection** to cover all existing and the new poor, combined with investment in the infrastructure of delivery, would ensure that help reaches people when they need it. Malaysia, with a universal national ID system, wide mobile phone coverage, and high financial inclusion, accomplished a large-scale cash transfer with a 99 percent implementation rate

that reached more than 10 million beneficiaries, or one-third of the total population. In contrast, many Pacific Island countries have underdeveloped social protection systems and need to institute flexible coverage that can adapt and be scaled up in response to large shocks.

- ***Devising strategies for smart schooling*** to protect students, staff, teachers, and their families—sanitary protocols, social distance practices, student re-enrollment—could prevent long-term losses of human capital, especially among the poor. School closures due to COVID-19 could result in a loss of 0.7 learning-adjusted years of schooling in EAP countries. As a result, the average student in the region could face a reduction of 4 percent in expected earnings every year of their working lives.
- ***Support for firms*** is needed to prevent bankruptcies and unemployment without unduly inhibiting the efficient reallocation of workers and resources to firms and sectors. Most EAP governments have extended support to firms but access was uneven, with only 10–20 percent of firms in some surveyed countries receiving assistance. Support must be based as far as possible on transparent and objective criteria related to not just past performance or current pain, but the potential to thrive in the future. And to avoid assistance being prolonged unduly, governments can commit to phasing it out by linking it to observable macroeconomic indicators of recovery. Many micro and informal firms operate outside of financial and tax systems, are hard to reach, and are best supported through social protection interventions.
- The crisis is accelerating four existing trends in trade: early recovery in the EAP region is reinforcing *regionalization*; aversion to overdependence in supply chains is encouraging the *relocation* of global value chains (GVCs) from China; digitization is boosting *servicification*; and a craving for self-reliance is increasing *protection* in some areas, even as countries liberalize in others. EAP countries need to ***deepen trade reform***, especially of still-protected services sectors—finance, transport, communications—to enhance firm productivity; avert pressures to protect other sectors; and equip people to take advantage of the digital opportunities whose emergence the pandemic is accelerating. China alone could add 0.5 percent to its own and regional GDP by extending the preferences in its bilateral agreement with the United States to all countries, while embarking on a program of deeper domestic reform and market opening.