

Reimagining emerging ASEAN in the wake of COVID-19

A focus on five key levers could both accelerate the region's recovery and make the gains more enduring

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No nation has escaped widespread disruption from COVID-19. But while the pandemic has affected nearly every country, its timing, the degree of its disruption, and the ability of countries to respond have varied significantly. Larger, developed nations have generally had the resources and infrastructure to weather the pandemic and provide a solid foundation for recovery. Less-developed countries, including emerging ASEAN (Indonesia, Malaysia, Philippines, Thailand, and Vietnam) began the crisis at a disadvantage, and COVID-19 exposed and often heightened their challenges.

McKinsey's research on emerging ASEAN countries explored a series of trends that the pandemic has caused or accelerated. Within these trends lie the potential recipe for recovery, but stakeholders must be prepared to reimagine their country's economy. Five key levers—manufacturing hubs, green infrastructure, investments in digital, talent reskilling, and high-value food industries—could not only speed up the economic recovery in these countries but also lay the foundation for extended growth.

COVID-19's impact on lives and livelihoods

Although the pandemic hit the Asian region first, its countries—including emerging ASEAN—have to date recorded significantly lower transmission and fatality rates per capita than other regions. As of August 20, 2020, transmitted cases per million people stood at approximately 582 across emerging ASEAN countries compared with 16,737 in the USA, 4,121 in the Eurozone, and 9,924 in Latin America. ASEAN countries also experienced lower death rates— 16 per million across versus 524 in the USA, 368 in the Eurozone and 388 in Latin America. If this trend holds, ASEAN countries could emerge from the COVID-19 pandemic with a significantly lower toll on lives compared with other regions.

So far, the lower fatality toll has not translated into a rosier economic outlook for many ASEAN countries.

In emerging ASEAN, governments generally weren't able to mount the same magnitude of stimulus programs as developed nations to cushion the pandemic's blow. Moreover, their significant informal economy and large unbanked population have hindered the distribution of relief aid. As emerging ASEAN leaders look to the next phase of the recovery, forecasts indicate that these countries could take a bigger hit to growth and face less certain prospects in the coming years.

McKinsey modeled nine potential economic outlook scenarios that reflected the effectiveness of virus containment and economic response. A survey¹ of 100 ASEAN executives found that 40 percent of respondents favored the A1 scenario, in which economic interventions would be effective in shoring up essential consumption but a recurrence of the virus was likely, leading to a second round of lockdowns. Eighteen percent of executives agreed with the A3 scenario, where initial measures would contain the virus and prevent repeated lockdowns. These results were in line with a larger survey of 2,500 global executives.

Under the A1 scenario, the global economy's growth rate would be -11.1 percent compared with Q4 2019 growth rates. Several emerging ASEAN countries could see a more drastic slowdown: Thailand (-13 percent), Malaysia (-13.5 percent), and the Philippines (-13.6 percent). Meanwhile, Indonesia's economy could see a decline of -10.3 percent, roughly on par with the global average. All of these countries are estimated to record annual GDP growth below that of the 2008 global financial crisis (-11.5 percent to -5.3 percent forecasted for 2020 compared with -2.2 percent to 4.5 percent in 2009)².

¹ See Sven Smit, Martin Hirt, Kevin Buehler, Susan Lund, Ezra Greenberg, and Arvind Govindarajan, "Safeguarding our lives and our livelihood: The imperative of our time", March 23, 2020, McKinsey.com.

² *Southeast Asian economic outlook 2010*, Organisation for Economic Co-operation and Development, November 9, 2010, read.oecd-ilibrary.org.

Five growth levers for emerging ASEAN to consider

The pandemic accelerated five trends in the ASEAN region. As Southeast Asian policy makers and executives turn their attention from reopening to reimagining their economies, these trends could be an engine propelling ASEAN's growth in the coming years.

1. Advancing as manufacturing hubs

Trade had been regionalizing in the years before the COVID-19 pandemic. Intra-Asia trade increased fourfold from 2000 to 2017 compared with growth in global trade of 2.8 times, as consumption demand from emerging Asian economies rose. Meanwhile, China's share of exports in labor-intensive manufacturing declined (down three percentage points from 2014 to 2016), as this kind of production shifted to other markets, with Southeast Asia as a leading alternative.

Intra-Asia trade is expected to fall 13 percent from 2019 to 2020 compared with a drop of 20 percent in East-to-West trade. The inclination of senior global executives to diversify supply chains from China to other Asian countries has intensified. Based on a survey of 150 global businesses by QIMA, 67 percent of EU executives and 80 percent of US executives said they intend to shift sourcing to other Asian countries.³

It follows that emerging ASEAN has a chance to attract new investment in labor-intensive manufacturing.

Several Southeast Asian countries have already taken steps in this direction:

- Thailand has announced policies to establish the country as an electric vehicle hub in five years, including use of electric vehicles by governmental organizations and state enterprises and the introduction of electric

buses and electric motorcycle taxis.⁴

- Malaysia has built up 4.3 gigawatts of solar-cell-module manufacturing capacity, making it the third-largest maker outside of China.⁵
- Vietnam has become a popular destination for electronics manufacturing, with companies such as Google and LG locating their smartphone manufacturing operations in the country.⁶

2. Investing in basic and green infrastructure

The green energy revolution has been a long time in the making, but the past few months have seen a spike in interest. Climate action remains critical over the next decade, and investments in green infrastructure and the transition to a lower-carbon future could spur significant near-term job creation. And with near-zero interest rates for the foreseeable future, there is no better time than the present for such investments.

The proportion of renewable energy generated as a percentage of total energy in China, the European Union, and the United States grew from 18 percent in 2005 to 27 percent in 2020 as the cost efficiency of these technologies improved. In the wake of the pandemic, countries are investing in green infrastructure to spur economic recovery and create jobs. The European Union, for example, unveiled an \$825 billion COVID-19 relief package that includes boosting clean energy and transport, with the goal of carbon neutrality by 2050. Likewise, China has announced its intent to attract \$500 billion in investment for "new infrastructure," including electric-vehicle charging stations.

Emerging ASEAN has an opportunity to unlock economic growth by doubling down on green infrastructure as well as addressing basic infrastructure gaps. For example, in Indonesia, 47 percent of households have no internet access⁷, and 11 percent do not have access to clean water⁸. In a fiscally constrained environment, policy makers could consider regulatory models that offer fair returns to encourage investment in these sectors.

³ Trade War: US Demand for China-based Inspections Drops by -13% as Other Regions Reap Benefits, qima.com

⁴ Online reporters, "Thailand 'to be regional EV hub' in five years," Bangkok Post, March 11, 2020, bangkokpost.com.

⁵ 'US solar panel tax casts a faint shadow on Malaysian manufacturers' *The Edge Malaysia*, February 7, 2018, theedgemarkets.com

⁶ Swati Gupta and Vipul Kumar, *Are electronics and automotive manufacturing companies shifting their base from China to Vietnam?*, Aranca, March 4, 2020, aranca.com.

⁷ Statista.com

⁸ Water.org

In addition, building out green infrastructure such as renewable and energy efficiency technologies could accelerate economic growth.

According to 2017 research by Heidi Garrett-Peltier, these technologies have nearly three times the job-creating impact of investment in fossil fuels⁹. Current share of renewables in power capacity stands at 11 percent in Indonesia, 22 percent in Malaysia, and 22 percent in Thailand, compared with an Asia average of 34 percent, leaving ample room for investment and expansion. Governments can accelerate penetration of renewables and energy-efficient technology in a few ways:

- **Build capabilities that enable climate-risk modeling and assessment of climate change economics.** This creates a fact base to inform recovery programs, develop improved infrastructure planning, and enable climate stress-testing in funding programs.
- **Invest in a broad range of sustainability levers.** These levers include building renewable-energy infrastructure, expanding the capacity of the power grid and increasing its resiliency to support increased electrification, retrofitting buildings, and developing and deploying technologies to decarbonize heavy industries.
- **Enhanced financial incentives that encourage consumer and business investment.** Policy makers could expand incentives to invest in distributed renewable generation (for example, solar panels) on commercial and residential premises and energy-efficiency technologies. They could employ schemes that allow consumers to sell energy back to the grid by introducing loans and grants that defray initial infrastructure investment costs.
- **Coordinate complicated and interdependent infrastructure rollout.** Large-scale infrastructure investment, such as electric-

vehicle charging networks and floating solar technology, requires coordination across multiple private and public sector entities to execute successfully. Governments can help address dependencies by taking on an explicit coordination role to facilitate communication between players, laying out frameworks that make clear how investors will be remunerated, and establishing regional rollout timelines.

- **Accelerating public sector uptake.** Governments are the owners of a vast amount of infrastructure in many countries, ranging from schools to offices. They could adopt energy-efficiency solutions across these premises, positioning themselves as leading consumers of green energy.

3. Preparing companies for a digital future

In the wake of the pandemic, digital technologies moved quickly from a strategic priority to an operational imperative—both to accommodate remote workers and serve consumers as they flocked to e-commerce channels. Lockdowns caused sharp increases in the adoption of digital channels across the world and within Asia, especially for spending on essential items. According to McKinsey's COVID-19 consumer pulse surveys, users of the online grocery channel grew by as much as 60 percent in the United States. Some 20 to 40 percent of customers in India, Japan, South Korea, the United Kingdom, and the United States also tried ordering food online for pick-up at grocery stores for the first time, and 50 to 80 percent of new customers in these countries have indicated they will continue using these channels once lockdowns lift.

The risk that these developments could leave small- and medium-sized enterprises (SMEs) behind could be managed through government support and programs. According to a McKinsey survey in 2018, 60 to 95 percent of digital revenue accrues to the largest 10 percent of companies in a sector.¹⁰

Yet SMEs account for a significant share of the region's economic activity, meaning that enhanced

⁹ Heidi Garrett-Peltier, "Green versus brown: Comparing the employment impacts of energy efficiency, renewable energy, and fossil fuels using an input-output model," *Economic Modelling*, February 2017, Volume 61, pp. 439-47.

¹⁰ "Unlocking success in digital transformations," October 29, 2018, McKinsey.com.

digital capabilities could translate to additional revenue. Increasing digital adoption to levels seen in developed markets could boost GDP growth by one percent in Malaysia; and technology transformations could add \$2.8 trillion to Indonesia's economy by 2040.¹¹

Capturing this opportunity requires three actions beyond building internet infrastructure:

- **Develop digital capabilities in companies.** While SMEs are often aware of the imperative to go digital, many are challenged to do so in practice. Southeast Asian countries could consider redirecting SME support toward digital capability-building programs. For example, Singapore offers the Industry 4.0 Human Capability Program, which helps 300 SMEs implement digital use cases and redesigns jobs to support them. In addition, the government's Scale-Up program supports local champions on a two-year growth journey with modules such as digital transformation and new business building.
- **Digitalize government processes to encourage adoption by companies and citizens.** To encourage wider use of digital tools by businesses and citizens, governments can digitalize their processes. Much of government procurement and invoicing in the region is still done by paper, offering the possibility of a shift to digitalization of business processes and channels. For example, the Indonesian government has partnered with Bukalapak, an Indonesian e-commerce company, to facilitate e-government services such as tax and utilities payments.
- **Provide financial incentives to boost digital adoption.** Introducing tax incentives, grants, and loans could encourage the adoption of digital tools. For example, in the aftermath of the pandemic, Singapore provided \$350 million in digital transformation grants for businesses to support e-payments and advanced digital-solution adoption.

4. Facilitating reskilling and redeployment at scale

For the past several years, business leaders have been preparing for the impact of automation and digital technologies on their workforce. The economic downturn is accelerating job displacement. In the A1 (virus recurs, leading to a second round of lockdowns) scenario, jobs at risk could increase by up to 878,000 in Malaysia, 4.5 million in the Philippines, 9.2 million in Indonesia, and 2.4 million in Thailand. Some 40 to 70 percent of jobs at risk from COVID-19 in Europe and the United States are already automatable under current technology, suggesting the possibility of long-term displacement even after the economy recovers.¹²

With job displacement may come opportunity. For example, the pandemic has moved society in the direction of contactless commerce, a development that could spur demand in the region for more skilled workers in digital fields. Increased demand for healthcare and related services may also lead to job creation.

Countries should consider making reskilling and redeployment support available at an unprecedented scale to address job disruptions from COVID-19

Such an effort could comprise three elements:

- **Facilitate a sufficient supply of reskilling and redeployment services.** Reskilling is most effectively undertaken in partnership with employers, but too often this task is managed by siloed training institutions. Facilitating partnerships across the corporate world to provide training can boost the volume and effectiveness of reskilling; for example, in New Zealand a coalition of companies made public commitments to double their on-the-job training and reskilling hours by 2025.
- **Provide funding to support demand for training.** During an economic downturn and mounting job losses, job seekers and employers alike may struggle to finance training. Providing government support to pay for a portion or all of these training

¹¹ "Innovate Indonesia: Unlocking growth through technological transformation," a joint report from the Republic of Indonesia Ministry of Finance and the Asian Development Bank, March 2020, adb.org.

¹² "The future of work in Europe" June 10, 2020, McKinsey.com

programs could help. For example, as part of COVID-19 stimulus, Singapore is offering a six- to 12-month training program, including a monthly allowance of S\$1,200 per participant for living expenses.¹³

- **Match supply and demand using data.** The jobs that disappear during the COVID-19 downturn may not be the same ones that return as the economy recovers. To encourage thoughtful reskilling, countries could analyze likely sources of economic growth and job opportunities, categories at risk from COVID-19 and automation, and feasible pathways for job seekers to transition into new opportunities. Talent Exchange, a platform set up by US-based eightfold.ai, is an example of a one such platform launched to match individuals displaced from work by COVID-19 with job opportunities.

5. Building high-value food industries

According to the World Bank, agriculture makes up a significant part of the economy for much of emerging Southeast Asia—12.7 percent in Indonesia, 7.3 percent in Malaysia, 8.8 percent in the Philippines, 8 percent in Thailand, and 14 percent in Vietnam. Strengthening and expanding the agricultural sector in these countries, especially through higher productivity, could increase its economic value-added while enhancing food security.

The pandemic has disrupted food security in three main ways: loss of income, channel shifts resulting in changing demand patterns, and supply interruptions. These issues have affected both low- and high-income countries. While restrictions on food exports have remained negligible for now, food security issues could intensify. Developed food-importing markets such as Qatar and Singapore have announced their intention to step up food security initiatives.

Hundreds of millions of people may be unable to afford enough food as a result of mass unemployment caused by the crisis and potential food price volatility. In addition, changing consumer preferences could lead to supply and demand

imbalances; for example, migration from foodservice channels led to an estimated 10 percent oversupply of milk in the United States in April 2020. Such disruptions put smaller businesses at risk, as they may not have the resources to outlast them. The exit of smaller businesses from the market could lead to supply gaps once demand rebounds.

Notwithstanding the global challenges stated above, there are two opportunities for domestic growth that stand out in the region's agricultural sector:

Raise farmers' productivity to aid competitiveness of local upstream production.

- Governments could coordinate the formation of cooperatives among smallholders to enable them to benefit from economies of scale, including sharing technology and management systems.
- Smallholders often operate with limited working capital and can survive only a few days in the event of an economic shock. Policy makers could make financing for working capital more easily available for solvent smallholders.
- Governments could provide technical support and assistance to encourage the deployment of technology.

Expand the agricultural sector into the downstream parts of the value chain, such as processing, packaging, and retail, to enable greater value capture.

- Demand for packaged food is likely to rise as emerging ASEAN economies develop; local industries can take advantage of this substantial business opportunity. Emerging ASEAN countries consume a lower proportion of packaged food compared with the global average and developed markets, except for Malaysia. For example, according to Euromonitor, packaged food sales in the Philippines and Thailand make up 58 percent and 60 percent of total food and beverage sales (excluding alcoholic drinks), respectively, compared with 77 percent in China and 81 percent in the United Kingdom.

¹³ "SGUnited Jobs & Skills," Government of Singapore, ssg-wsg.gov.sg.

- Stakeholders should make a concerted effort to attract relevant foreign investors in the sector. Such an initiative would involve identifying global downstream players in key agribusiness sectors, understanding the enablers needed to attract those participants, and putting them in place (for example, by introducing global players to local agribusiness enterprises in noncompeting subsectors that could give the foreign investors access to local distribution networks).
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The COVID-19 pandemic is a story of lives and livelihoods. To date, the countries of Southeast Asia have managed to limit the rate of infections and the number of deaths associated with the disease. The next step will be to spur an enduring economic recovery through identifying and activating the right levers. To do so, policy makers and executives could seek to reimagine their countries' economies and invest in job-creating policies and technologies that could position them well in the years to come.

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