Briefing note

Understanding Asia's middle-income challenge in 2025

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Key messages

- While half of the world's population in 2025 will most likely live in Asian middle-income countries (MICs), these MICs differ markedly with respect to vulnerability to shocks. Development partners need to continue to support them, albeit in a changing way.
- The economic performance of many Asian countries remains robust but there are also likely to be several MICs with persistent pockets of poverty, vulnerability to income shocks and high inequality.
- Changes in China-centred global value chains and the advent of the Belt and Road Initiative will pose opportunities and challenges for regional economies. Effective national policies, backed by regional and global cooperation, can help sustain Asia's future economic dynamism.
- In a changing Asia, development partners should continue their support to MICs, but the partnership needs to change gears from an aid-focused approach towards trade and private investment. All of these approaches incorporate economic and private sector development, but the emphasis and primary focus differ.

Introduction

Structural transformation of developing Asia from a poor, agricultural backwater to a prosperous, global manufacturing hub was the most important economic development achievement of the 20th century. The region is diverse, with sub-regions and countries of varying population sizes, geographies and economic dynamism, as well as different vulnerabilities. While the economic performance of many Asian countries post-global financial crisis has remained robust, there are likely to be several middle-income countries (MICs) with persistent pockets of poverty, vulnerability to income shocks and high inequality.

This briefing[1] provides a quantitative and qualitative regional macroeconomic picture of Asia over the next few years. It examines economic prospects and responses to shocks in the region's MICs and how development partners need to adapt and tailor their instruments, modalities and approaches to respond to these challenges.

Macroeconomic projections

We examine what developing Asia's economic landscape might look like in 2025 by reviewing recent performance and presenting macroeconomic projections for 46 economies across 5 Asian sub-regions as well as Australia, Japan and New Zealand. Several projections are noteworthy.

By 2025, half the world's population (4.3 billion people) will live in developing Asia amid a demographic transition to an ageing population. South Asia's population will likely swell to 2 billion and East Asia's to 1.5 billion. Asian giants India and China – respectively with 1.5 billion people and 1.4 billion people by 2025 – will continue to dominate. Southeast Asia is likely to hold about 700 million people by 2025, with over a third of this total living in Indonesia.

Excessive post-crisis growth pessimism seems misplaced, although there is debate as to whether the current upsurge signals the start of a cyclical global recovery post-global financial crisis or a blip on a long road to a timid and fragile global recovery. World growth picked up to 3.8% in 2017 – the fastest and broadest global upsurge since 2011 – and developing Asia will continue to play a key role in bolstering this. The region grew at 6% in 2017 and is projected to grow at a slightly slower pace annually until 2025. Meanwhile, South Asia – led by a buoyant India – could become a powerful engine of regional growth. East Asia's growth is likely to slow reflecting a moderating growth trajectory in China. Southeast Asia could see stable growth, with improved performance in Indonesia and the Philippines. Stable growth is expected in Central Asia, owing to the expectation of higher oil and gas prices, and in the Pacific.

The revised world economic outlook is attributed to an amplified global growth momentum that could translate into stronger external demand for Asia's manufactured exports and increased inward investment. Better-than-expected results in 2017 in China, the favourable effects of higher prices for commodity exporters and fiscal policy in Japan are playing a supporting role.

The region's trade growth is expected to be supportive of its gross domestic product (GDP) growth, at least in the short term. This reflects a pick-up in investment spending in developed economies, better import demand for Asian goods, higher intra-regional shipments in global value chains (GVCs) and improved consumer confidence. However, the region's elasticity of trade growth to GDP growth, which peaked at 1.8 in 2000–2007 before the crisis, is projected to fall to 0.9 in 2019–2025. This is a worrying trend, given the region's historically high reliance on trade-led growth to fuel its prosperity.

Fast growth in comparison with other regions means developing Asia's share of world GDP in current market prices could rise from 26.2% to 30.5% between 2017 and 2025. In purchasing power parity (PPP) terms, the region's share of world GDP could rise from 37.5% to 42.5% between 2017 and 2025. The region's five largest economies in 2017 – China, India, Indonesia, Republic of Korea and Singapore – could continue to dominate the region's economic landscape in 2025.

Developing Asia's income per head in current market prices could increase from \$10,476 to \$15,428 between 2017 and 2025. Remarkably, this would put developing Asia within the World Bank's current definition of high-income economies. However, glaring disparities in income per head are visible between the sub-regions and economies over the forecast period. East Asia remains the richest sub-region and South Asia the poorest. Between these come Southeast Asia, Central Asia and the Pacific. The five poorest economies are likely to be Afghanistan, Kyrgyz Republic, Nepal, Tajikistan and Uzbekistan.

Rising trade protectionism, monetary tightening and rising interest rates, geopolitical tensions between the United States and China and natural disasters could affect these macroeconomic projections.

The prospects and challenges of three 'mega-trends' for Asia's economies

Three 'mega-trends', risks and opportunities are likely to influence the course of the region's economic development up to 2025, and specifically that of recently graduated MICs.

1 Briefing based on Wignaraja et al. (2018), which is an output of a partnership between Australia's Department for Foreign Affairs and Trade (DFAT) and ODI. See Wignaraja, G., Tyson, J., Prizzon, A. and te Velde, D.W. (2018) *Asia in 2025: development challenges and prospects for middle-income countries*. ODI Report. London: Overseas Development Institute.

First, the performance of China-centred GVCs. The extent of East Asia's participation in GVC trade is significantly greater than that of the rest of developing Asia, and has spurred the region's global rise to coveted 'Factory Asia' status, with rapid growth and job creation over a long period. An important feature of Factory Asia is China's emergence as a regional supply chain hub, undertaking final assembly of parts and components produced in other parts of Asia. However, China-centred GVCs are slowing, with threats and opportunities for industrial latecomers in Southeast Asia and South Asia. Opportunities could stem from (i) multinational corporations exploring alternative regional locations for labour-intensive segments of GVC manufacturing; (ii) China's deepening industrialisation and the growing local roots of its GVCs; and (iii) GVC-related services as a new form of trade. These trends are likely to benefit China as well as other regional economies, including India, Indonesia, Malaysia, Thailand and Viet Nam.

To realise these GVC opportunities, latecomers need to improve their business environments in targeted ways and firms should adjust their business strategies, by ensuring competitive wages with high labour productivity, targeting foreign direct investment and providing reliable infrastructure. Donors can be valuable in implementing targeted reforms for latecomer entry into GVCs, in supporting small and medium enterprise participation in GVC activities and in better understanding the risks of technological disruptions and re-shoring in Asian GVCs.

Second, the Belt and Road Initiative (BRI). Central to the BRI is an infrastructure construction programme of intercontinental transport, energy and telecommunications linking China to other Asian countries, Africa and Europe. This will be financed predominantly by China's policy banks and carried out by Chinese firms. It will be accompanied by the encouragement and support of investments by private Chinese firms in host countries. The ambitious BRI offers both opportunities and risks for China and the rest of developing Asia. It has the potential to deepen economic and political ties and spread prosperity to a greater range of countries than before. But multiple risks resulting from the BRI – such as those related to debt sustainability, environment and governance standards, financial stability and political relations – will require careful management at global and regional level, as well as in individual developing Asian economies. Donors can help facilitate the smooth implementation of the BRI.

Third, pockets of poverty and vulnerability amid prosperity. Most developing Asian economies are now classified as MICs (or high-income). In 2025, Afghanistan and Nepal are expected to be the only two possible exceptions, still to be classified as low-income countries. Rapid growth and increased health and education spending mean the region stands out when it comes to its rapid fall in the share of population living below the extreme poverty line and its swift improvements in human development. However, such trends are occurring amid development challenges, including pockets of persistent poverty, income vulnerability and growing income inequality. Some countries continue to confront fragile situations associated with long-term and often subnational conflict. There is also a risk of some countries facing rising inequality as growth has not always been pro-poor and external shocks remain problematic.

Identifying successful and vulnerable countries and economies in Asia

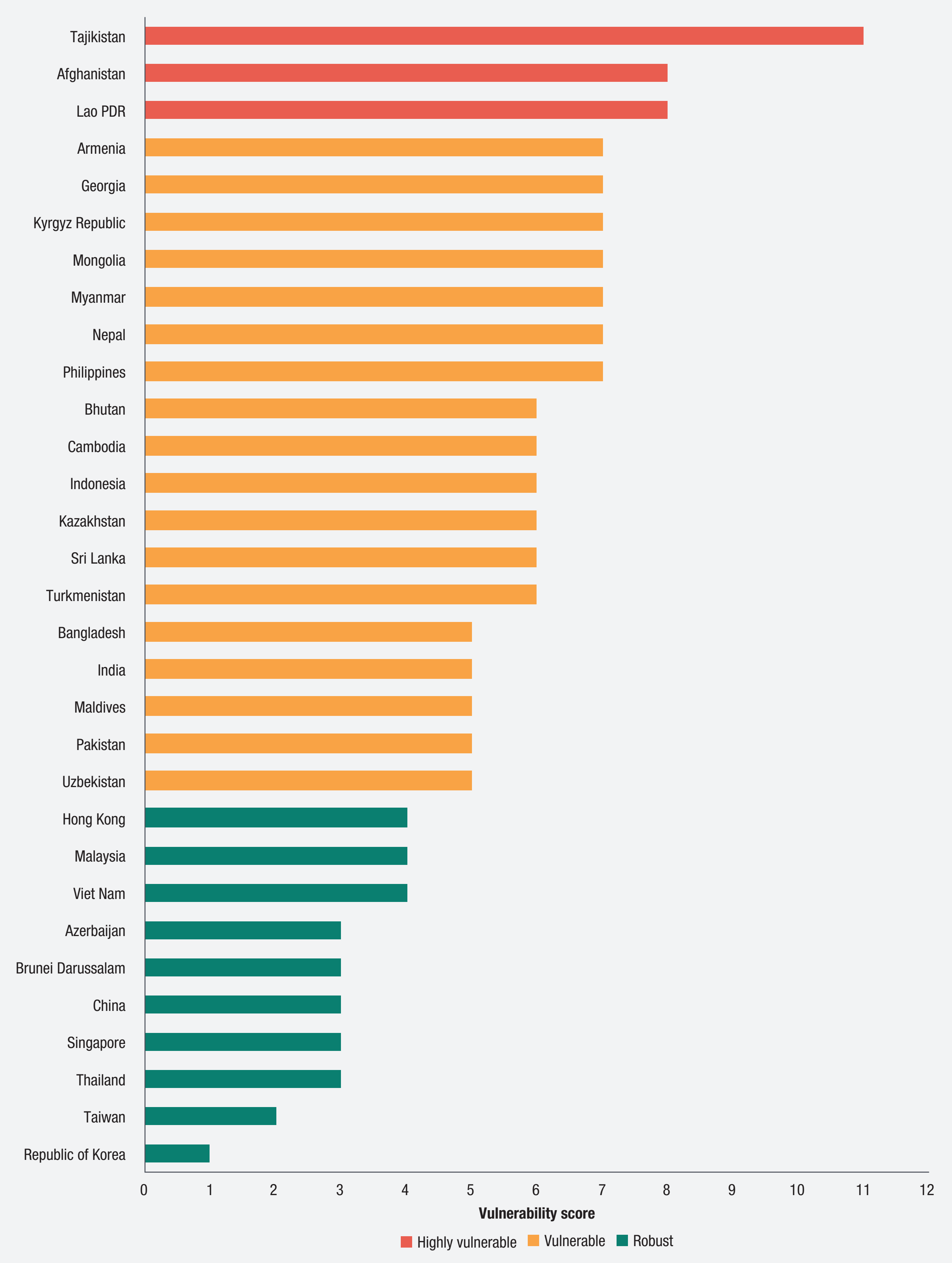
We assess the vulnerability of developing Asia-Pacific economies against the macroeconomic outlook and the three mega-trends identified above. We distil quantitative indicators by ranking countries according to economic vulnerability in six dimensions: economic prospects, trade capabilities (to take advantage of GVCs), debt accumulation associated with the BRI, social development, population dependency and special vulnerabilities related to national circumstances, for example fragility or adverse geography (small island economy or landlocked country). Countries and economies are grouped in Figure 1 into three distinct groups: (i) highly vulnerable, (ii) vulnerable and (iii) robust. We exclude Pacific Island countries owing to data limitations.

The key findings on the rankings are as follows:

- The three highly vulnerable economies mapped by macroeconomic prospects/shocks, population dependency and the three 'mega-trends' are Afghanistan, Lao PDR and Tajikistan.
- The 18 vulnerable economies are Armenia, Bangladesh, Bhutan, Cambodia, Georgia, Kazakhstan, Kyrgyz Republic, India, Indonesia, Maldives, Mongolia, Myanmar, Nepal, Pakistan, the Philippines, Sri Lanka, Turkmenistan and Uzbekistan.
- Myanmar and Kyrgyz Republic seem to be at the higher end of the vulnerability scale and risk falling into the highly vulnerable category.
- The remainder are considered robust, and include China, Hong Kong, Republic of Korea, Malaysia, Singapore, Taiwan and Thailand.

The main report (Wignaraja et al., 2018) includes a sensitivity analysis and compares our vulnerability score with other vulnerability scores.

Figure 1 The 'vulnerability score' by country/economy



Notes: The score is composed of GDP per capita in PPP (2025), trade capability (2016), debt sustainability (2023), income inequality (most recent estimate), population dependency ratio (2025) and special vulnerability.
Source: See Wignaraja et al. (2018), Table 5.

Conclusions and implications for development partners

In 2025, half the world's population will most likely live in MICs in Asia. However, poverty and income inequality could persist amid prosperity. Changes in China-centred GVCs and the advent of the BRI initiative will pose opportunities and challenges for regional economies. Effective national policies, backed by regional and global cooperation, can help Asia sustain its future economic dynamism.

These trends have general implications for development partners, in addition to the specific responses to the challenges identified above. The region's development cooperation landscape is fundamentally shifting, within the context of an 'age of choice' in terms of increasing numbers of providers of development finance. Some countries (such as China and India) are shifting from being aid recipients to donors but still have limited national fiscal space to finance development projects. Bilateral donors increasingly consider trade and investment linkages in addition to aid.

Although it is a simple tool to highlight exposure to risks, the vulnerability index can inform development partners on appropriate national approaches. We divide such approaches of bilateral donor agencies in the region into three different categories:

1. In an aid-focused approach, development agencies help restore peace, rebuild countries after conflict or natural disasters and address the most basic human needs. They also kickstart economic development, for example supporting 'highly vulnerable countries', including, where feasible, the use of the private sector.
2. In an aid and trade approach, development agencies phase out aid grants and move towards loans on increasingly less concessional terms. This would involve an increased role for trade relationships to encourage countries to trade more, grow faster and raise domestic resources and reduce aid dependency, for instance focused on 'vulnerable economies'.
3. In a trade and private investment approach, donors (using only very limited aid resources) are engaged in economic dialogue and foster mutually beneficial trade and investment linkages in those countries classified as 'strong/robust'.

Development partners should not move from an aid relationship simply to no relationship at all, as we argue that in many MICs vulnerabilities loom large. Instead, when partner countries transform, donors should be moving towards a different relationship that is based on aid *and* trade, and, eventually, trade and private investment, depending on the existing vulnerabilities in partner countries. In moving to a trade and investment relationship, development partners will need to respond to the specific vulnerabilities and opportunities of the countries in question. Economic development and private sector development play a role in all of these approaches, but the emphasis and primary focus differ.

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