ASIA'S NEW GROWTH CHALLENGE

As societies age and trade fragments, policymakers must adapt to sustain growth and support rising living standards

Krishna Srinivasan

Illustration by Tang Yau Hoong

In the industrial zones on the outskirts of Ho Chi Minh City, a new generation of semiconductor assembly and electronics plants operates around the clock, supplying components essential to global tech giants—and lifting the economy up the value chain.

In Vietnam, like Korea a generation ago, economic stability and openness to trade and foreign investment are transforming its economy and dramatically lifting living standards. This is the kind of transition that powered Asia's economic miracle. And now that model is increasingly under strain as the conditions that sustained decades of success undergo rapid shifts.

Asia increasingly drives the global economy, accounting for nearly 40 percent of output and two-thirds of growth—up from a quarter in the 1990s (see Chart 1). This rise lifted hundreds of millions of people out of poverty and made it the world's factory. Today it's increasingly a hub for innovation, services, and finance.

Sustaining strong and inclusive growth is harder to achieve in an uncertain, aging, and fragmented world. Policymakers must balance competing priorities—efficiency and resilience, innovation and inclusion—while addressing short-term pressures without sacrificing long-term prosperity.

Momentum and headwinds

Sustaining this progress is getting harder as old growth models reach their limits. Productivity gains are slowing, because industrialization pays fewer dividends. The region also faces intense demographic pressures constraining labor supply and potential growth in several economies. This raises the question of whether Asia will grow old before getting rich.

At the same time, trade, long the key engine of growth, is faltering. Reliance on external demand has exposed export-oriented economies, such as China, Korea, and Southeast Asia, to trade shocks amid increasing fragmentation. And high levels of energy intensity and dependence on energy imports add another layer of vulnerability, exposing economies from Japan to Indonesia to energy shocks driven by distant conflicts and the climate transition.

Artificial intelligence and other rapid technological advances are already helping turbocharge growth. But they also risk disrupting jobs and widening divides between those best placed to benefit and others who may be left behind.

The future of Asia depends on how policymakers manage these transformations.

Productivity and investment

Productivity growth—the ultimate driver of sustained income gains—has slowed across much of Asia since the global financial crisis. While investment remains high, returns to capital have declined, reflecting rising misallocation and diminishing efficiency. Credit is abundant, but financial systems remain heavily bank-centric. This favors large incumbents, including state-owned enterprises, over younger, faster-growing, and more innovative firms. As a result, resources often remain trapped in less productive enterprises, dampening dynamism and innovation.

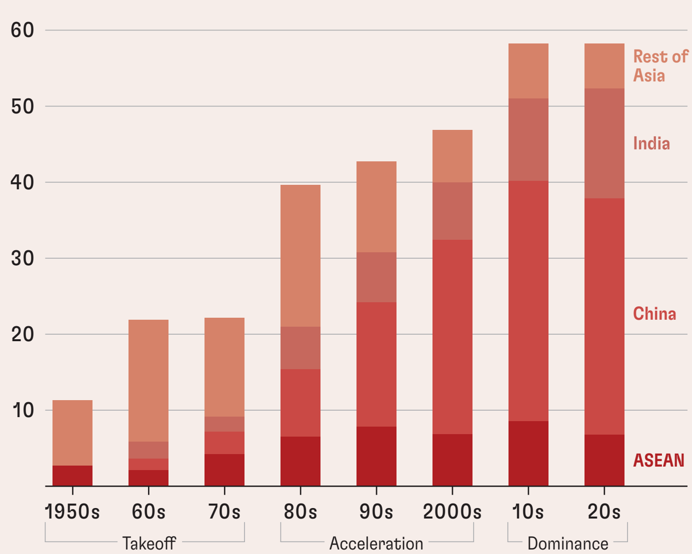
Sustaining growth will require shifting from *more* to *better* investment and strengthening financial systems so that capital flows to its most productive uses. Asia can pivot toward boosting productivity rather than capital accumulation by improving financial access, deepening capital markets, and expanding venture finance. Capital flows to more productive recipients when it's priced and allocated on market terms. This boosts innovation and supports a more efficient growth model.

CHART 1

Powering growth

Asia now accounts for about two-thirds of global growth.

(contribution to global real GDP growth, percent, PPP GDP weighted)



SOURCE: IMF, *World Economic Outlook*. **NOTE:** 2020s includes data for 2020–25 only. PPP = purchasing power parity.

Aging populations

Demographic change is perhaps the most powerful—and least avoidable—force shaping Asia's growth prospects. Since the 1960s, fertility rates across Asia are down sharply—from about 6 children per woman to about 1.6 today—while life expectancy has risen from roughly 50 years to the mid-70s. By 2050, one in five people in Asia will be 65 or older—double today's share—making aging a shared regional reality.

But the region is not aging uniformly (Chart 2). At one end are rapidly aging economies, such as Japan, Korea, and China, where shrinking workforces are already weighing on growth. In the middle are countries like India, Malaysia, and Vietnam, where demographic dividends are fading. And at the other end are younger economies, such as Nepal and the Philippines, where labor forces continue to expand. It's a window of opportunity that must be seized.

This divergence has important implications. For aging economies, boosting productivity and leveraging AI and other technologies will be critical to offset labor shortages. Younger economies need enough high-quality jobs to absorb growing labor forces and avoid a missed demographic dividend.

Without policy action, aging will slow labor force growth while raising fiscal pressures through pensions and health care spending. Targeted policies can help mitigate these effects by raising labor participation among women and older people, investing in skills, and facilitating mobility. Migration, both within and across borders, can also help if well managed.

Trade fragmentation

Trade integration fueled Asia's growth, embedding the region deeply into global value chains. Asia now accounts for roughly a third of global trade, with increasing intraregional linkages. But the global trade environment is changing.

Geoeconomic fragmentation is reshaping trade patterns, supply chains, and investment flows while raising uncertainty in manufacturing employment and economic growth. Governments are responding with more active industrial policies, but our analysis points to significant challenges in achieving durable competitiveness and resilience through these interventions without distorting incentives or further fragmenting markets.

As global integration becomes increasingly difficult, intraregional ties offer a vital opportunity to harness untapped potential. Less than 30 percent of final goods exports is traded within the region, half the share in Europe and North America.

The Association of Southeast Asian Nations, a group of 11 countries that would rank as the world's fourth-largest economy, is a case in point. The bloc is highly open to global trade, with volumes exceeding its economic output. Yet trade within ASEAN accounts for less than a quarter of total trade—far below other regional blocs.

This disconnect reflects structural constraints, including limited logistics infrastructure, uneven human capital development, and nontariff barriers. The question, then, is how to close this gap and better tap the region's potential.

More comprehensive, enforceable regional agreements—covering services, digital trade, competition policy, and standards—can lower trade costs and improve access, thereby boosting productivity. Evidence suggests that deeper integration could raise regional real GDP by about 1.8 percent in the long run—equivalent to adding an economy larger than Thailand's today. Gains would be even larger if reforms were coordinated across countries (Chart 3).

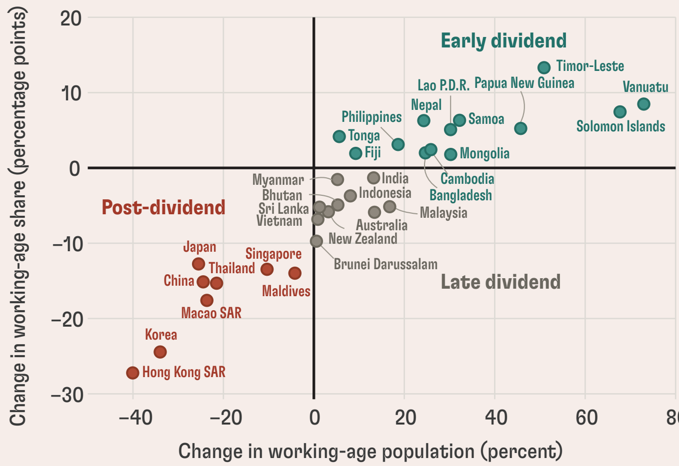
Unlocking the full potential of these reforms calls for fiscal space to manage transition costs, offset revenue losses from tariff reductions, and support needed investment in complementing reforms. Tax revenue in much of Asia, notably in many ASEAN economies, is low relative to peers. Raising more domestic revenue will be critical to

CHART 2

Demographic shift

Asia's economies are at different demographic stages and face different trade-offs.

(Asia and the Pacific, 2025–50)



SOURCES: UN, *World Population Prospects 2024*; and IMF staff calculations.
NOTE: Working-age = 15–64; dividend stages reflect the path of the working-age population and its share of the total.

finance the investments needed for deeper regional integration and sustained growth.

Looking ahead, services will define the next phase of integration and structural transformation. In many economies, manufacturing has already peaked as a share of output, while services—particularly finance, information technology, and business process outsourcing—increasingly drive growth.

In India, for example, modern services account for about a quarter of exports, driven by software engineers in Bengaluru who design and manage digital systems worldwide. In the Philippines, millions work in business process outsourcing that provides customer service, tech support, and data analytics.

The expansion of services is further underpinned by rising incomes and shifting demographics. In this context, rebalancing toward domestic demand should be part of the broader shift toward balanced growth, supporting resilience in an increasingly fragmented global economy with mounting challenges for export-led growth.

Technology and growth

As traditional growth drivers weaken, new technologies—especially AI and digitalization—can be a powerful way to reinvigorate growth. Asia already leads in digital adoption, with about 90 percent of the population online. And it accounts for more than two-thirds of global innovation in digital technologies.

> "As global integration becomes increasingly difficult, intraregional ties offer a vital opportunity to harness untapped potential."

AI has particular potential to transform production of goods and services. By enabling sophisticated automation and augmenting human capabilities, it can boost productivity even in aging societies with shrinking workforces. Better prepared economies, like Japan and Korea, are already using AI in manufacturing, robotics, and services, while others are rapidly expanding digital infrastructure and skills.

Yet the benefits of AI are unlikely to be evenly distributed. Early adopters—typically economies with higher-skilled workers, greater capital intensity, and better institutional capacity—stand to gain the most. In Asian countries with such strong fundamentals, AI could raise growth by up to 1 percentage point per year relative to a no-AI baseline, our model-based analysis suggests. This is particularly important for aging advanced economies such as Japan and Korea, where AI can offset the drag from shrinking workforces. Later adoption in lower-income countries could widen regional disparities, especially if global investment demand raises financing costs.

Within countries, AI may intensify wage and opportunity gaps, benefiting high-skilled workers in complementary roles with wage gains through higher productivity. Others may be displaced.

Policymakers will shape outcomes. Investment in education, digital infrastructure, and innovation can accelerate adoption. Labor policies, such as retraining and support for worker mobility, can ease the transition. And redistributive policies can help ensure that AI's gains are widely shared and support workers who lose jobs.

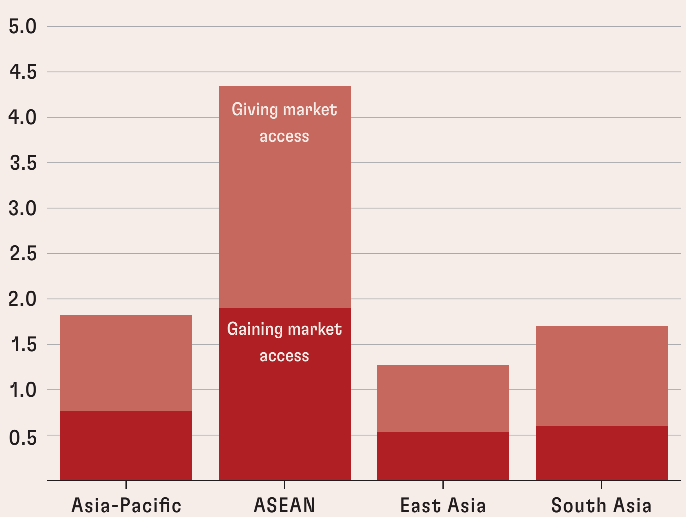
Digitalization complements this transformation by increasing the efficiency of financial transactions. India is a good example: Its digital payments move trillions of dollars each year, transforming transactions society-wide. Digitalizing tax and payment systems can raise government revenues while improving the efficiency and transparency

CHART 3

Growth gains

Southeast Asia stands to gain the most from deeper regional integration.

(real GDP gains from deepening regional integration, percent)



SOURCE: IMF staff calculations.

of public spending. Yet significant digital divides remain, particularly across lower-income countries and within nations.

This requires a comprehensive policy framework. Governments need to invest in digital infrastructure, build digital platforms such as identity and payment systems, strengthen regulation to ensure trust, and expand digital literacy.

Defining fault line

Meanwhile, energy security is no longer a long-term concern—it is a near-term macroeconomic challenge, nowhere more so than in Southeast Asia.

Continued reliance on imported fossil fuels is colliding with rapidly rising energy demand, driven by Vietnam's industrial expansion, Singapore's data centers, and Indonesia's urbanization. Recent price shocks have clearly exposed vulnerabilities.

At the same time, countries are beginning to pivot. Vietnam is scaling up renewables to support manufacturing, Indonesia is exploring a shift away from coal, the Philippines is diversifying to depend less on imported energy, and Thailand has made the energy transition a policy priority. Falling renewables costs and advances in storage are easing this transition even as digitalization and AI sharply raise electricity demand.

The challenge is to move fast without compromising affordability or reliability. Done right, the payoff is large: greater energy security, less exposure to external shocks, and a new engine of resilient growth for the region.

Sustaining Asia's growth

Asia's extraordinary achievements lay a powerful foundation for success, though that's not guaranteed. The region now faces a defining decade.

A shrinking population is expected to subtract about 0.3 percentage point from growth annually by 2050, while productivity gains from AI and related technologies could add 0.2 to 1 percentage point. Together, these forces suggest that growth in Asia could remain close to or even exceed recent historical averages if productivity gains are fully realized. Additional gains from trade integration could lift growth further by about 0.1 to 0.3 percentage point.

This underscores the need to sustain growth through the right policies to ensure a continued shift toward productivity, inclusion, and sustainability. This requires strengthening skills, institutions, and how technology is used.

Some countries are leading the way. Efforts to digitalize economies—from India's digital public infrastructure to ASEAN's expanding fintech—are improving efficiency, inclusion, and tax revenues. AI adoption is reshaping production, spanning advanced manufacturing in Korea and Japan to services and logistics across emerging Asia.

From Korea then to Vietnam now, Asia has driven the world's growth. If it falters, the global economy will feel the costs. And if it thrives, the world will benefit. F&D

KRISHNA SRINIVASAN *is director of the IMF's Asia and Pacific Department.*