Paper to be presented at UACES Conference in Passau-Sep 2012

Impact of Financial and Sovereign Debt Crisis on EU-East Asia Economic Partnership[1]

Lay Hwee Yeo, EU Centre in Singapore / Singapore Institute of International Affairs

Abstract

The 2008 financial and economic crisis had its origins in the developed economies of the west but quickly spread to Asia as liquidity issues led to a credit squeeze with impact on the real economy. Although developed countries were more affected than developing countries, the crisis led to a collapse in global trade and all countries were affected, particularly export-oriented Asian economies. It debunked the growing belief that the Asian economies have decoupled from the West. This paper analyses the consequences of the ongoing financial and debt crisis on the economic partnership between the European Union and East Asian countries and considers the implications that a recession in the euro area might have on the EU's trade and investment relations with China, Korea, Japan and the ASEAN countries. It then contemplates the broader trends of the new economic circumstances facing the EU and East Asia, and how they would impact overall EU-East Asia partnership in this changing landscape of global economic governance.

INTRODUCTION

Global trade almost collapsed at the height of the global financial crisis reaching its lowest point in March 2009 before starting to progressively recover in 2010. International trade has returned to normal in 2011 and hopes were high for a sustained recovery. Unfortunately the risk of a more severe economic crisis and a period of stagnation remain high in particular as "the outlook for the European economy has taken a turn for the worse"[2] because of the sovereign debt crisis in the eurozone.

The global financial crisis of mainly private debts (sub prime mortgages), liquidity issues and credit squeeze, triggered by the collapse of the Lehman Brothers has now morphed into that of a severe sovereign debt crisis affecting first the periphery of the European economies, and now threatening the whole Eurozone. After the initial disclosure of the Greek financial troubles in 2009, inadequate crisis management and half-baked measures had led to nervousness in the financial markets. This nervousness has since

---

[1] This paper is adapted from an earlier Policy Brief published by FRIDE that the author jointly prepared with Ms Anne Pollet-Fort, Associate at the EU Centre in Singapore

[2] European Commission, , Europe Economic Forecast, European Economy 6, 2011, p.1, http://ec.europa.eu/economy_finance/publications/european_economy/2011/pdf/ee-2011-6_en.pdf

then spiral into a loss of confidence in many of the countries in the Eurozone leading to a vicious circle of crises feeding into one another. And since the first bailout package for Greece in 2010, the sentiments in the Eurozone have not improved but continued to deteriorate.

The EU has entered into a zone of uncertainty and great instability, and what impact this will have on EU-East Asia economic partnership is the subject of this paper.

FROM GLOBAL FINANCIAL CRISIS TO EUROZONE SOVEREIGN DEBT CRISIS

The 2008 global financial crisis and the ensuing sovereign debt crisis in the Eurozone have severely affected the growth prospects of the European Union. According to IMF forecast, the Eurozone area in 2012 will suffer a contraction of 0.3% and GDP growth is predicted to be only 0.7% for 2013. For the whole of the European Union, the European Commission is predicting zero growth in 2012, but projected to increase by 1.3% in 2013. Growth in general would be anemic for the next few years.

The EU economic slowdown will undoubtedly have an impact on the East Asian economies as the EU is an important trade partner and has been an important contributor to the Asian countries' export-led growth. The EU is China's biggest trading partner. It is ASEAN's second largest trade partners, and ranked 3rd and 4th in its trade partnership with Japan and South Korea respectively. The EU is also an important investor in several of the East Asian economies, and FDI flows with these various economic partners have been considerably affected. For example, in 2010 EU outward flows decreased for the third consecutive year, down 62% compared with 2009[3].

A further deterioration of the EU's economy as a consequence of the unresolved euro crisis will therefore be felt in East Asia since the EU is a major source of trade, investments and also of tourist arrivals in East Asia. However, as illustrated below, the impact and consequences will vary depending on the specific characteristics of the EU trade with each of the East Asian economies and their respective economic structures. The ability of East Asian economies to replace reduced external demands by increased domestic demands, their ability to diversify into other markets, their fiscal position and capacity and their exposure to foreign bank loans will determine how large the impact of the Eurozone crisis will be.

---

[3] *Eurostat, Foreign Direct Investment Statistics, May 2011, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Foreign_direct_investment_statistics*

EU-China

China has the biggest direct trade exposure to the EU. The impact of the global financial crisis on the EU directly affected the Chinese economy. The average annual growth of the EU trade with China in value terms between 2006 and 2010 was around 11.2%, with respectively 9.7% for EU imports from China and 15.4% for EU exports to China. However there was a sharp decline in EU-Chinese trade in 2009 with EU imports of Chinese goods dropping at -13.7% and EU exports to China only progressing at only +5.1%. Trade rebounded in 2010 with EU imports from China increasing at a rate of +31.7% and EU exports to China increasing at a rate of + 37.2% and exceeding the pre-crisis level of EU-China total trade in millions of euro[4]. Trade continued to improve in the first half of 2011 but the prospects for 2012 and beyond remain uncertain in view of the uncertainties linked to the euro crisis. In fact the continued turmoil in the Eurozone through the first half of 2012, and the tepid recovery of the US economy has brought about a broader slowdown in China.

The EU is also the largest foreign investor in China, accounting for 20% of foreign direct investments (FDI) into China. If EU-27 investment flows to China were generally less affected than flows to other economic partners like the US for example, they fell in 2008, before rebounding by 11 % in 2009. Preliminary results for 2010 suggest that FDI flows from the EU-27 to China fell by 16 %[5].

Despite the slowdown in investments from the EU, FDI in China continue to grow with a double-digit growth rate. Investment flows to China from the Asia-Pacific region, including Japan, Malaysia and Singapore, for example, saw an increase of 23.67% in the first seven months of 2011[6].

The global financial and economic crisis and the shrinking external demand also contributed to variations in the Chinese GDP growth. The World Bank has recently revised downwards its GDP growth forecast for China to 9.1 percent for this year and 8.4 percent for 2012, citing impact of the European debt crisis and shrinking external demand. The latter has been further revised downward as Chinese growth momentum slides at a higher than expected pace in 2012. Growth in China is predicted to be just around 8%.

---

[4] European Commission, China, Main economic indicators, 2010, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113366.pdf

[5] *Eurostat, Foreign Direct Investment Statistics, May 2011, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Foreign_direct_investment_statistics*

[6] China Daily, FDI flows to China still strong, 19-08-2011, http://usa.chinadaily.com.cn/business/2011-08/19/content_13152364.htm

EU-Japan

The evolution of the EU-Japan trade differs from the other EU-East Asian situations, showing far less buoyancy. Originally characterized by strong trade surplus in favour of Japan, the EU Japan trade relations has become more balanced recently as Japan started in the last decade to reform its economy and open its market further to international competition. While the Japanese banking sector was less affected by the 2008 financial crisis than its American and European counterparts, Japan has still been affected by the global economic downturn, with its economy slowly recovering from the stagnation of the 90s. The 2011 devastating earthquake and tsunami further threatened the Japanese economic recovery.

This has had direct consequences on the EU-Japan trade that declined in value terms at an annual average annual of – 2.9% between 2006 and 2010[7], with an annual average decrease of -4.3% for EU imports and an average annual decrease of -0.6% for EU exports to Japan. In 2009, EU imports from Japan dropped by – 24.4% and EU exports to Japan declined by -14.7%. Despite a rebound in 2010 of + 14.4% for EU imports from Japan and of +21.3% from EU exports to Japan, EU trade with Japan did not reach back its pre-crisis level.

The EU has been the largest investor in Japan for many years and FDI flows between the EU and Japan have shown important variations in recent years. However, worryingly, EU FDI flows to Japan decreased steadily in 2008 and 2009 and turned into a disinvestment in 2010[8].

EU-Korea

EU trade with Korea remained relatively stable in recent years with an annual average variation of +1.1% in value terms between 2006 and 2010. This figure comprised an annual average decrease of -1.4% for EU imports and an average annual increase of +5.2% for EU exports to Korea. However in 2008, EU imports from Korea started to decline by – 4.3% and further decreased by a huge -18.4% in 2009 before rebounding by

---

[7]European Commission, Japan, Main economic indicators, 2010, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113403.pdf

[8] Eurostat news release 74/2011, EU-Japan summit, 26 May 2011, http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/6-26052011-AP/EN/6-26052011-AP-EN.PDF

19.7% in 2010. EU exports to Korea decreased by -15.4% in 2009 before rebounding at + 29.3% in 2010[9].

Following the entry into force of the EU-South Korea Free trade agreement on 1st July 2011, trade volume between both partners rose with both exports from South Korea to the EU and exports from the EU to South Korea rising[10].

The EU is the biggest investor in South Korea and EU FDI inflows into Korea continue to increase in 2008 and 2009. The first consequences of the crisis on EU investment into Korea were felt in 2010 with a decline of 8.8% of EU FDI inflows into Korea. Korea's GDP growth which declined in 2008 and 2009 rebounded in 2010 and is expected to reach an annual rate around 4% beyond 2011. However, because of the Korean economy's high volume exposure on foreign bank loans, the ongoing debt and banking crises in the Eurozone is likely to impact Korea quite hard. The sluggish growth of the EU economy has hit Korea hard and in 2011, growth was only at 3.3%, with forecast of only a 2.5% growth in 2012. The negative impact of the Eurozone crisis has unfortunately mitigated the gains that were expected from the EU-Korea FTA.

EU-ASEAN

The average annual growth of the EU trade with ASEAN between 2006 and 2010 was around 3.6%, with 2.3% for the imports and 5.6% for exports. In 2009 at the height of the global financial crisis and beginning of the Greek crisis, there was a sharp decrease in trade between both partners. EU imports from ASEAN declined by -14.8% and EU exports to ASEAN by -9.7%. However trade rebounded in 2010 with an increase of the EU imports from ASEAN of 27.1% and an increase of EU exports to ASEAN of 20.6%. As a consequence the level of trade between the EU and ASEAN in 2010 is higher than pre-crisis level. Many observers however expect a decrease from this higher level as a consequence of the uncertainties linked to the euro crisis.

The EU is the largest investor in ASEAN countries but FDI inflows declined as a consequence of the crisis. The figures for FDI vary from an outflow to the ASEAN countries of EUR 25 billion in 2008 to EUR 6 billion in 2009[11]. The sharp decline in

---

[9] European Commission, Korea, Main economic indicators, http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113448.pdf

[10] The Wall Street Journal Asia, EU-South Korea trade jumps as FTA takes effect, 18/07/2011, http://blogs.wsj.com/korearealtime/2011/07/18/eu-sk-trade-jumps-as-fta-takes-effect/

[11] ASEAN-EU - trade and investment statistics *Data from July 2011, http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/ASEAN-EU_-_trade_and_investment_statistics*

demand towards ASEAN exports led to a decline in investment in the ASEAN export-oriented manufacturing industries.

The average annual growth rate for ASEAN has followed the variations of the trade figures with a lowest point in 2009 and a rebound in 2010. Forecast indicate that South-east Asian expansion is likely to moderate and that the annual GDP growth rate for 2011 and beyond will be around 5.5%.

Because of ASEAN's increasing integration with the Northeast Asian economies of Japan, Korea and in particular China, the impact of the euro crisis has been softened somewhat by its continued expansion of ties with China. The slowdown in China because of the continued uncertainty in the Eurozone would probably have a greater impact on the economies of ASEAN.

AN ONGOING CRISIS - WHERE ARE WE NOW?

The policy measures and the crisis management mechanisms that the Eurozone countries have applied so far to address the euro crisis have often been judged as insufficient and inadequate by the markets leading to a spiral downwards. The sovereign debt crisis is no longer just about bad debts. It has been revealed that at the core of this is a fundamental banking crisis, leading to broader macroeconomic imbalances. Compounding the economic problems are the legitimacy and governance crises at the political level.

If uncertainties continued, and conditions worsen in the Eurozone, the impact on East Asia would become more severe. The impact would clearly be on the trade front since most East Asian economies are export-oriented and trade dependent. As political mood in the EU darkens with the long drawn crisis, the temptation to resort to protectionism cannot be ruled out.

On the financial front, as the Eurozone crisis intensify, this is likely to lead to global credit squeeze as seen in 2008/09, and drastic drop in bank lending and portfolio investments. This in turn will further impact the real economy and trade flows because of difficulties in trade-financing.

However, beyond the immediate economic repercussions are also the broader geopolitical and geo-economic implications of the crisis, on the EU itself, and on the EU's ability to remain as a role model of successful integration, and hence its influence globally as a normative or soft power. How would this in turn shape the future of EU-East Asia partnership?

IMPLICATIONS FOR THE FUTURE OF EU-EAST ASIA ECONOMIC PARTNERSHIP

It is difficult to determine the precise impact of the decrease in the trade flows between the EU and East Asian countries on the GDP growth of these countries, though it would certainly hit those economies that are particularly trade dependent. With the closely intertwined global financial system, stresses in the financial and banking systems in the EU would also have contagion effect on East Asia. However, the impact on each economy would depend on the degree of integration into the global market. Countries for instance such as Cambodia, Myanmar that are not plugged into the global financial system would not be affected through the financial channel.

However, the general dependence of East Asian economies on external markets has made most East Asian economies more vulnerable to the deterioration of the economic situation in the EU. The Head of IMF, Christine Lagarde underlined recently that Asia could be badly affected if the crisis in Europe deepens. The uncertainty and the lack of a clear growth strategy within the EU, the weak recovery in the US and the slowdown of the Chinese economy is weighing heavily on the global economic outlook.

To mitigate the impact of the slow growth and weak recovery in the EU and US, East Asia would need to work on further economic integration in the region. The work towards ASEAN Economic Community and the launch of discussions on a possible trilateral free trade agreement among China, Japan and South Korea are important steps towards East Asian economic integration. Progress has also been achieved in the area of monetary and financial cooperation amongst the East Asian economies.

The Chiang Mai Initiative (CMI) launched in 2000 comprising a network of bilateral currency agreements have now been multilateralised (CMIM) following the global financial crisis of 2008. A pool of funding of US$120 billion was set up, with the proportion of the amount of contribution between ASEAN and the Plus Three countries kept at 20:80, respectively. In parallel, in order to support the potential option of delinking the access to CMIM funds from conditionalities imposed by IMF, a regional surveillance mechanism, in the form of the ASEAN + 3 Macroeconomic Research Office (AMRO) was set up in 2011[12].

Besides the currency cooperation embodied in CMIM and AMRO, APT countries have also since the Asian Financial Crisis strived to develop its own Asian regional bond markets as alternative channels for raising capital. The Asian Bond Market Initiative (ABMI) that was endorsed by the APT Finance ministers at a meeting in 2003. Under this framework, a number of working groups were set up to address the technical issues of

[12] Natasha Hamilton-Hart. "Regional and Multi-level Governance: East Asian leadership after the Global Financial Crisis" in *Asia Europe Journal*, Special Issue on Leadership, Decision-making and Governance in EU and East Asia, Vol 9, Numbers 2-4, March 2012, pp 237 – 254

developing bond markets. An Asian Bond Fund (ABF) was also set up by East Asian and Pacific Central Banks to invest directly in markets. Another concrete step taken after the onslaught of the global financial crisis was the establishment of a $700 million trust fund in April 2010 with primary contributions from ADB and the Plus Three countries that will guarantee bonds issued in regional currencies[13].

The further economic integration within East Asia would slowly dilute the importance of the EU to East Asia. Despite a rebound in trade between the EU and Asian countries in value terms in 2012, the Asian share of exports to the EU has diminished. There is increased re-orientation of Asian trade towards other Asian partners, and in particular China. China is fast replacing advanced economies such as US and the EU as the central country within the growing intra-Asian trade, and also an increasing important player in other South-South trade. The Chinese market is becoming more and more important for not only the less developed ASEAN countries, but also Japan, and the tiger economies. The EU need to continue a broad engagement of all the East Asian economies and work closely with all the countries to get out of current crisis, and yet at the same time mindful that China is fast becoming one of its key competitors in the growing East Asian markets. EU's trade agenda will also need to take note of the increasing importance of South-South trade.

There is also growing unease that as the crisis in the Eurozone worsens and unemployment remains record high, political mood in the EU will also darken. EU citizens' trust of the competency of the EU is at a new low of only 31% and Euro skepticism is on the rise. Far right political parties and movements which use to be on the fringe are getting more support and moving into the centre stage of EU politics. As the EU becomes more self-absorbed with the management of its internal problems, and insecurity sets in with rise of economic nationalism and protectionism, the EU would lose traction as a role model of successful integration.

EU leaders cognizant of the underlying tensions would nevertheless need to continue to keep in check protectionist sentiments as allowing "beggar-thy-neighbour" policies would only lead to fragmentation of the global economy into competing regional blocs.

CONCLUSION

The global financial crisis and the ensuing sovereign debt crisis in the Eurozone have serious repercussions for the real economy. The EU despite its anemic economic recovery and plagued by the crisis in the Eurozone remained the world's largest and

---

[13] Jikon Lai and John Ravenhill. "Asia's Multi-level Response to the Global Financial Crisis" in *Asia Europe Journal*, Special Issue on Leadership, Decision-making and Governance in EU and East Asia, Vol 9, Numbers 2-4, March 2012, pp 141 -157

richest trading bloc. The East Asian economies driven by the growth of China, and renewed vitality of key ASEAN economies would be an important engine to keep the global economy growing. Despite the various challenges, the EU and East Asia must not lose sight of the importance of trade and investments to the fundamental well being of their societies, and hence should step up efforts in cooperation to stabilize the financial markets, rebuild confidence and sustain the growth momentum in the global economy.

References:

Eurostat and European Commission data

Hamilton-Hart, Natasha. "Regional and Multi-level Governance: East Asian leadership after the Global Financial Crisis" in *Asia Europe Journal*, Special Issue on Leadership, Decision-making and Governance in EU and East Asia, Vol 9, Numbers 2-4, March 2012, pp 237 – 254

Lai, Jikon and John Ravenhill. "Asia's Multi-level Response to the Global Financial Crisis" in *Asia Europe Journal*, Special Issue on Leadership, Decision-making and Governance in EU and East Asia, Vol 9, Numbers 2-4, March 2012, pp 141 -157

"EU-South Korea trade jumps as FTA takes effect", The Wall Street Journal, Asia, 18/07/2011, http://blogs.wsj.com/korearealtime/2011/07/18/eu-sk-trade-jumps-as-fta-takes-effect/

"FDI flows to China still strong", China daily, 19-08-2011 http://usa.chinadaily.com.cn/business/2011-08/19/content_13152364.htm