

## EU-Asia trade relations: getting through the crisis

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»» The 2008 financial and economic crisis had its origins in the developed economies of the West but quickly spread to Asia. Liquidity issues led to a credit squeeze, with an impact on the real economy. Although developed countries were more affected than developing countries, the crisis led to a collapse in global trade to an extent that raised concerns in export-oriented Asian economies. It debunked the growing belief that Asian economies have decoupled from the West.

This policy brief analyses the consequences of the ongoing financial crisis for trade and business relations between the European Union (EU) and East Asian countries. It considers the implications that a recession in the euro area might have on EU trade relations with China, Korea, Japan and the Association of South East Asian Nations (ASEAN). The new economic circumstances facing the EU and East Asia have far-reaching implications for the EU-East Asia partnership. European exports to Asia have recovered faster than imports from the region. But growing concerns over the economic outlook in East Asia threaten the upward trend in EU exports in the absence of policy efforts to conclude new trade accords. Trends in trade and investment suggest that both European and East Asian governments need to reassess their approaches to this partnership if damage is to be mitigated in the long term.

### Highlights

- EU trade with East Asia dipped dramatically after the financial crisis but has now recovered.
- There are growing concerns that Asian economies will be hit hard by the latest phase of the euro crisis and that trade and investment with Europe may again suffer.
- Retaining trade shares in Asia increasingly requires the EU to compete with China's growing regional presence.

»»»» **IMPACT OF THE CRISIS**

Global trade almost collapsed at the height of the global financial crisis; it reached its lowest point in March 2009 before starting progressively to recover in 2010. International trade returned to normal trend levels in 2011. But the risk of a more severe economic crisis and a period of stagnation remains high because of the sovereign debt crisis.

The crisis led to a fall in foreign direct investment (FDI) flows globally. In particular, EU-27 FDI flows have been strongly affected by the crisis. In 2010, EU outward flows decreased for a third consecutive year, and were down 62 per cent on 2009 levels.

In 2012, real GDP growth is expected to slow to 1.6 per cent for the EU-27 and 1.5 per cent in the euro area. 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 partner, and ranks third and fourth as a trade partner for Japan and South Korea respectively. The EU is also an important investor in several East Asian economies. A further deterioration of the economy in Europe and the risk of recession as a consequence of the unresolved euro crisis will be felt in East Asia.

**EU-China** China has the biggest direct trade exposure to the EU. Trade declined

as a result of the crisis but quickly recovered to historically high levels. The average annual growth of the EU trade with China in value terms between 2006 and 2010 was around 11.2 per cent. EU imports from China grew at 9.7 per cent; EU exports to China expanded by 15.4 per cent. There was a sharp decline in EU-Chinese trade in 2009. In this year, EU imports of Chinese goods dropped by 13.7 per cent; EU exports to China increased but by only 5.1 per cent. Trade rebounded in 2010 with EU imports from China increasing at a rate of 31.7 per cent and EU exports to China increasing by 37.2 per cent. Trade in 2010 exceeded the pre-crisis level of EU-China total trade in millions of euro. Trade continued to improve in the first half of 2011, although the prospects for 2012 are uncertain in view of the latest phase of the euro crisis.

The EU is also the largest foreign investor in China. It accounts for 20 per cent of FDI into China. EU-27 investment flows to China were generally less affected by the crisis than flows to other economic partners like the U.S. They fell in 2008, before rebounding by 11 per cent in 2009. Preliminary Eurostat figures for 2010 suggest that FDI flows from the EU-27 to China fell by 16 per cent.

Despite the slowdown in investments from Europe, FDI to China continues to exhibit a double-digit growth rate. Investment flows to China from the Asia-Pacific region increased by a notable 23.6 per cent in the first seven months of 2011. However, the World Bank has recently revised downwards its GDP growth



## The EU needs to deepen and broaden its engagement with all East Asian economies

forecast to 8.4 per cent for 2012, citing the impact of the European debt crisis and shrinking external demand.

**EU-Japan** The evolution of EU-Japan trade differs from other EU-East Asian trends, showing far less buoyancy. Originally characterised by a strong trade surplus in favour of Japan, the EU-Japan trade relationship has recently become more balanced as Japan has started to reform its economy and open its market to international competi-

tion. While the Japanese banking sector was less affected by the 2008 financial crisis than its American and European counterparts, Japan has still been hit by the global economic downturn. The devastating earthquake and tsunami in 2011 further threatened Japan's economic recovery. Japan's annual GDP growth

rate has been moderate in the last five years with projections for 2011 and 2012 indicating a GDP growth rate close to nil.

This has had direct consequences for EU-Japan trade. This trade declined in value terms at an annual average of 2.9 per cent between 2006 and 2010. This was broken down into an annual average decrease of 4.3 per cent for EU imports and an average annual decrease of 0.6 per cent for EU exports to Japan. In 2009, EU imports from Japan dropped by a sizeable 24.4 per cent and EU exports to Japan declined by 14.7 per cent. Despite a rebound in 2010 of 14.4 per cent growth for EU imports

from Japan and of 21.3 per cent for EU exports to Japan, EU trade with Japan has not returned to its pre-crisis level.

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

**EU-Korea** EU trade with Korea remained relatively stable in recent years with an annual average growth of 1.1 per cent in value terms between 2006 and 2010. This figure comprised an annual average decrease of 1.4 per cent for EU imports and an average annual increase of 5.2 per cent for EU exports to Korea. However in 2008 EU imports from Korea declined by 4.3 per cent and further decreased by a huge 18.4 per cent in 2009. They then increased by 19.7 per cent in 2010. EU exports to Korea decreased by 15.4 per cent in 2009 before rebounding with a 29.3 per cent increase in 2010. Following the entry into force of the EU-South Korea Free trade agreement in 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 markedly.

The EU is the biggest investor in South Korea and EU FDI inflows into Korea continued 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 per cent of EU FDI inflows into Korea. Korea's GDP growth



declined in 2008 and 2009, rebounded in 2010 and is expected to record a growth rate of around 4 per cent beyond 2011.

**EU-ASEAN** The average annual growth of EU trade with ASEAN between 2006 and 2010 was 3.6 per cent; 2.3 per cent for imports and 5.6 per cent for exports. There was a sharp decrease in trade between the two partners in 2009. EU imports from ASEAN declined by 14.8 per cent and EU exports to ASEAN by 9.7 per cent. From 2009 to 2010 trade rebounded with an increase of EU imports from ASEAN of 27.1 per cent and an increase of EU exports to ASEAN of 20.6 per cent. As a consequence, the level of trade between the EU and ASEAN in 2010 is higher than pre-crisis levels. But many observers now 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 €25 billion in 2008 to €6 billion in 2009. The sharp decline in demand for ASEAN exports led to a decline in investment in ASEAN export-oriented manufacturing industries.

The average annual growth rate for ASEAN has followed the variations in trade figures with a low point in 2009 and a rebound in 2010. Forecasts indicate that South East Asian expansion is likely to be moderate and that the annual GDP growth rate for 2011 and beyond will be around 5.5 per cent.

## **IMPLICATIONS**

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. However, the dependence of East Asian economies on external markets has made these countries more vulnerable to the deterioration of the economic situation in the West and hence shrinking demand from the EU and the U.S. IMF head Christine Lagarde underlined recently that Asia will play a key role in global recovery but that the region could be badly affected if the crisis in Europe deepens. The uncertainty and the lack of a clear growth strategy within the EU, the continued weak recovery in the U.S. and the slowdown of the Chinese economy is weighing heavily on the global economic outlook.

Looking at the trade and growth data of the EU and East Asian countries, four main points are worth noting that may influence future policy developments in East Asia, with implications for broader EU-East Asia relations.

First, the evolution of EU imports from and EU exports to China, Japan, Korea and ASEAN suggests that EU exports are recovering faster than EU imports from Asia. This may be an indicator that East Asian countries have been less affected by the economic downturn, and that expansion of their domestic markets will be an important equation for the global recovery.

While EU FDI outflows decreased as a consequence of the crisis, inward investment into the EU-27 from Asia increased in



### Annual variation of EU imports from

	ASEAN	China	Japan	Korea
2009	-14.8%	-13.7%	-24.4%	-18.4%
2010	+27.1%	+31.7%	+14.4%	+19.7%

### Annual variation of EU exports to

	ASEAN	China	Japan	Korea
2009	-9.7%	+5.1%	-14.7%	-15.4%
2010	+20.6%	+37.2%	+21.3%	+29.3%

2010 after a decline in the previous years. In particular, inward FDI flows from China and Hong Kong rose in relation to 2009. The level of Chinese FDI remains relatively low; China only represents 1 per cent of all FDI into the EU. The EU is likely to receive far more investment by Chinese firms as China has become an active investor abroad and now ranks among the 10 largest global investors. While global investment falls, China outward investment is still growing fast. The possible expansion in Chinese investment will need to be properly addressed in European public debate as concerns over investment by state-owned Chinese companies and sovereign wealth funds are growing.

Second, as emphasised by the WTO, in spite of strong protectionist pressures, protectionism in the EU has been kept in check. However, if the economic situation continues to worsen, it cannot be excluded that major economies may retreat from their commitment to the global trading system and seek recourse to more protectionist policies. Though a difficult

imperative on which to focus minds now, the EU should assume its responsibility as the world's largest trading partner and step up efforts to negotiate free trade agreements with East Asian economies.

Third, despite a recent rebound in trade between the EU and Asian countries in value terms, the Asian share of exports to the EU has diminished. This suggests a reorientation of Asian trade towards other partners and in particular China. In the case of Korea for example, China already counts for a quarter of its exports. More generally and as underlined by the World Bank, the recovery in trade has been dominated by strong demand from developing countries, which has accounted for more than half of the increase in global imports. Developing countries themselves are becoming drivers of export-led growth. In view of the increasing importance of global production networks, it is too early to say whether these exports to other developing countries are used for internal consumption, or for manufacturing goods for the EU or other developed countries



as a final destination. In any case, in the future, the EU's trade policy agenda will need to take the increasing importance of South-South trade into account.

Fourth, China is fast replacing advanced economies such as the U.S., EU and Japan as the pivotal country within growing intra-Asian trade, and also an increasingly 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. Continued increases in intra-Asian trade and investment flows have contributed to East Asia's economic integration. Yet, China is also now a target of protectionist measures coming from the South, and if the overall global economic outlook worsens, the growing South-South trade may also stall.

In conclusion, the EU needs to deepen and broaden its engagement with all East Asian economies and work closely with all these countries to emerge from the current crisis. At the same time it must be mindful that China is fast becoming one of its key competitors in the growing East Asian markets.

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