Smart Q&A
No. 2012-16

The Euro Zone Crisis and the Outlook for China's Economy

September 26, 2012

Interviewee

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Despite the severity of the ongoing euro zone crisis, China – a substantial exporter to the EU – has been one of the less affected countries. In the following Smart Q&A, Hwan-woo Jung of Korea International Trade Association assesses China's response to the euro zone crisis, and further predicts the outlook for its economy. The following is a summary of the main policy recommendations from this interview.

Q1: How has China responded to the ongoing euro zone crisis?

A1: "China's policies are focused on minimizing the negative impact of the euro zone crisis upon its economy. Specifically, it has put a stop to the appreciation of the renminbi (RMB), reduced its trade dependence on developed markets, and accelerated its transition to a domestic-based economy."

- Despite its purchase of Greek and Portuguese government bonds and various attempts to increase investment, China's efforts to solve the euro zone crisis have been fairly limited. That is because Beijing not only prioritizes stable management of foreign exchange reserves, profitability, and risks, but also prefers state-centered strategic investments. Hence it is difficult for Beijing to expand its investment in the EU states without any economic considerations. In fact, China appears to be primarily concerned with limiting the negative impact of the euro zone crisis upon its economy, rather than solving the crisis itself.

- One example is its exchange rate policy. From 2010 to 2012, the Chinese government pursued import expansion policies – even at the expense of its exports – largely through the gradual appreciation of the RMB. However, following the advent of the euro zone crisis, China redirected its policy to expand exports. Specifically, it put a stop to the appreciation of the RMB, and began managing the currency's exchange rate to hold it steady.

- The Chinese government has also been working toward diversification of its exports to reduce its trade dependence on developed markets, such as those of the EU and the United States. As a result, China's exports to EU countries, which used to comprise about 20 percent of total exports in 2008, had decreased to 17 percent of total exports in the first half of 2012. A decrease in trade dependence by three percentage points in only three to four years is a substantial change, and reflects the Chinese government's efforts to secure new markets in Southeast Asia, South America, the Middle East, and Africa.

This product presents a policy-oriented summary of the Smart Q&A.

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- Finally, China has recently picked up the pace of its long pursued transition from an export economy to a domestic-based one. Although China's dependence on exports is not too high when compared to that of other Northeast Asian countries, the Chinese government is nevertheless pursuing a diverse range of policies in its domestic industry and technology to boost consumption. This effort aims to reduce the possibility of an economic contraction due to a decline in exports.

Q2: What is the outlook for China's economy?

A2: "The decline in China's growth rate is not a sign of hard landing but instead reflects the government's intentional adjustment of growth rate based on its twelfth five-year plan."

- The negative impact of the euro zone crisis on China's economy is most evident in the field of exports. From January to May of 2012, China's export growth rate was 8.7 percent - a figure that is pretty high in comparison with other countries, but quite low when compared to its own previous levels. Many argue that this downward trend in China's exports to the EU has led to a slowdown in China's GDP growth rate.

- However, before analyzing the negative effects of the slump in exports on China's economy, one must first take a look at China's processing trade system. Under this system, China imports raw and auxiliary materials from abroad, processes them, and then re-exports the final products. During this process, domestic producers are exempt from tariffs and import-related taxes. The system essentially grants a favor to the producers within China, who have been coping with low-levels of capital and a large labor force ever since China began its reform and opening up. In fact, China only receives a small amount of revenue – through wage labor – from its exports under this processing trade system. Hence, an accurate analysis of the impact of changing levels of exports upon China's economy should not take into account processing trade. Therefore, true exports comprise only 18 to 20 percent of China's GDP (2010), rather than the previous level of 35 percent. In short, the slump in China's exports – caused by the euro zone crisis – actually had a limited impact upon China's economy.

- Still, the euro zone crisis places a burden on China's economy. In fact, China's GDP growth rate fell from 7.8 percent in the first quarter of 2012 to 7.6 percent in the second quarter. Based on this trend, some argue for the need to prepare for a hard landing of China's economy, but this perception depends on whether or not Beijing can make up for the decline in exports with development in other areas. During the recent global financial crisis, China overcame the crisis through massive investments rather than through exports, and contributed significantly to the global economic recovery. Specifically, beginning in 2009, the Chinese government carried out 13 regional development plans within just a year and a half, and mobilized the local governments to promote investment. As a result, China succeeded in stimulating its economy, although its policies had the negative side effect of severely increasing local government debt. Similarly, China will probably respond to the euro zone crisis by boosting investment and domestic demand. Given the debt problems of the local governments, China will likely resort to a domestic stimulus package instead of an extensive investment policy, but the latter is still an option, as the local governments appear to be capable of further expanding their investments. Therefore, the possibility of a decline in exports – caused by the euro zone crisis – leading to a hard landing appears to be unlikely for two main reasons: 1) exports comprise a fairly small proportion of China's economy; and 2) China is still capable of using a domestic stimulus package or boosting its investment.

- Moreover, the Chinese government announced in its twelfth five-year plan that it will maintain its level of annual economic growth rate at 7.5 percent until 2015. The plan reflects Beijing's efforts to minimize the negative side effects of many years of high growth, such as the formation of financial bubbles and uneven regional development, and have a period of adjustment to become a domestic-based economy that can maintain a stable level of growth. The current level of China's growth rate is close to the goal set by the Chinese government, so expecting a hard landing of the economy based on these figures is not accurate.

Q3: How should South Korea respond to the crisis?

A3: "South Korea should pursue regional economic integration to increase intra-regional consumption, thus departing from a system of development characterized by production within the region and exports to outside the region.

- From January to May of 2012, China's export growth rate was 8.7 percent, while the same figure for South Korea, Taiwan, and Japan were 0.4 percent, -5 percent, and -6 percent, respectively. The main reason for this disparity lies in the previously mentioned processing trade system. For instance, South Korea's exports to China involving processing trade comprise a staggering 45 percent of total exports. Taiwan and Japan are in similar situations. As a result, the impact of the euro zone crisis has more negative effects on the countries that actually export the products after using China as a base for processing products than it does to China. From this we see the gap between the export growth rates of China and those for other Northeast Asian countries.

- South Korea should no longer use China simply as a base for processing products. Instead, South Korea should use the Chinese domestic market itself as its engine for growth. Furthermore, there is a need for enhanced economic integration in Northeast Asia. It is important to pull away from the current international division of labor, in which Northeast Asia serves as a global "factory" while developed and emerging markets serve as consumer markets. Rather, Northeast Asia should both produce and consume, and strive to build a new international economic order. By increasing the proportion of intra-regional trade across the three Northeast Asian countries, especially through free trade agreements, it will be possible to establish a system largely invulnerable to external shocks in the long run.

About the Interviewee

Hwan-woo Jung received his PhD in political science from Hankuk University of Foreign Studies, and is currently serving as a research fellow at Korea International Trade Association's Institute for International Trade.

Prepared by the Asia Security Initiative Research Center at the East Asia Institute. As an Asia Security Initiative core institution, the East Asia Institute acknowledges the grant support from the MacArthur Foundation that made this event possible. The East Asia Institute takes no institutional position on policy issues and has no affiliation with the Korean government. This report was summarized in Korean by Ha-jeong Kim and Yang Gyu Kim on August 29, 2012 and translated into English by Jae-Yeop Kim and Stephen Ranger.