The Euro-area Crisis: Impact on Asia (and other regions)

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How to think about the impact?

- Channels for transmission
  - Trade
  - Finance

- Applicable to
  - Latin America
  - Africa

Credit: i.telegraph.co.uk/multimedia/archive/02027/Asia-EU-storm_2027378c.jpg
Trade Effect (1)

– Most countries in Asia have a high trade/GDP ratio, and Europe is often ¼ of the total export market.
  • Trade openness is higher in East Asia than South Asia
  • But the raw “trade openness” can be misleading …
  • True dependence should be based on the domestic content in exports
  • Koopman, Wang and Wei: Estimating domestic content in exports while taking into account processing trade
Chinese domestic content in exports is low (about 50%) but increasing overtime

source: Koopman, Wang, and Wei (JDE 2012)

- China’s exports are about 32% of GDP
- Its domestic content in exports is about 18% of GDP
- Domestic content in exports to Europe is about 5%
- Cutting exports to Europe by half would mean a reduction in total demand by 2.5%

Trade Effect (2)

– How large is the trade effect? Ability to replace reduced external demand by increased domestic demand differ across countries
  • Depends on country size (or the relative importance of exports)
  • Fiscal capacity
– Country conditions matter; no homogenous effect
  • China has both the size and capacity advantage
  • Singapore has a relatively strong fiscal position but too small a domestic market
  • India has the size edge but weak fiscal capacity
  • The Philippines has disadvantages in both size and capacity.
– Similar criteria should help us think about Latin America and Africa
The Finance Effect (1)

• Many countries have a high exposure to international capital flows, including bank loans and FDI from Europe

• How much would a deeper crisis in Europe affect developing countries depends on
  - Total volume of exposure
  - Structure of exposure (the ratio of FDI to non-FDI flows) Tong and Wei, RFS 2010

Figure 1: Capital Flow to Emerging Economies (in US$ Billions)

Source: Tong and Wei, Review of Financial Studies, 2010
The Finance Effect (2)

• Country conditions matter
  – Korea has a high volume exposure, and relies mostly on foreign bank loans
    • Strongly vulnerable to a worsening Euro crisis
  – India has a medium level of exposure, but also relies relatively more on non-FDI flows
    • Also vulnerable to a worsening Euro crisis
  – China has a high volume exposure, but relies overwhelming on inward FDIs
    • Less vulnerable to a worsening Euro crisis
“A rich man is someone who is richer than his brother-in-law”

• While a deeper crisis in Europe represents a negative shock to almost all countries in Asia, and indeed to almost all countries anywhere in the world,

• ... it creates differentiations
  – China will emerge relatively stronger
    • Because
      – Both the trade effect and the finance effect will be relatively milder for the country than elsewhere