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China and the Global Financial Crisis: Implications for Low-income Countries

How the financial crisis affects China has implications that extend well beyond its domestic economy. As the world's third largest economy, China's ability to maintain growth and restructure its domestic economy is critical for addressing global macroeconomic imbalances. How the financial crisis affects China will also affect many low-income economies, whose recent growth has in part been stimulated by China's demand for commodities and intermediate inputs, and its expanding overseas investments.

China's financial institutions are relatively well insulated from the direct impacts of crisis. Its export dependence has however resulted in a sharp downturn in the real economy. The government has responded with an extensive package of measures aimed at stimulating the economy, raising domestic demand and maintaining stability. Given the continued decline in both exports and imports, growth rates for 2009 continue to be revised downwards, possibly to as low as six per cent.

What are the implications for low-income economies?

China affects other low-income economies both indirectly and directly. Indirectly, the increased price of commodities in response to China's demand has benefited many low-income economies in Latin America and sub-Saharan Africa. A fall in demand from China, on top of collapsing commodity prices, will negatively affect these countries.

The main direct channels of economic influence are trade, investment and, to a lesser extent, aid, all of which have increased significantly in recent years. These are closely related and, particularly in the case of Africa, reflect China's political and strategic interests as well as long-term economic objectives. It is therefore unlikely that there will be any significant downturn in China's direct engagement with Africa in these three areas, at least in the short to medium term.

In terms of trade, China's inelastic demand for natural resources, combined with a heavily infrastructure-focused stimulus package, should maintain demand for key commodities such as oil, cotton and copper at a time of otherwise falling global demand and deteriorating terms of trade. By contrast, those countries providing intermediate products for China's export manufacturing (particularly in South East Asia) will see demand fall. In 2008 total China-Africa trade increased by 45 per cent to US$107 billion, exceeding the US$100 billion target set in 2006 when trade was US$55 billion, and giving Africa a trade surplus for the first time.

Given this past growth, China's exports to Africa may shrink, but African demand for light industrial and consumer products is unlikely to be seriously affected. Potential problems arising from the increased value of China's currency should be offset by a corresponding drop in the price of Chinese imports. So trade in the next three years will probably continue to increase but at a slower rate than over the past two years.

In terms of investment, there is little reason to expect significant reduction in China's public and private investments in Africa. State enterprises are clearly taking advantage of opportunities created by the crisis to increase investments, especially in the energy sector. New deals are being made, and China is seeking investments in commodities that are important for its long-term food and energy security, and growth.

Increased competition during a downturn may accelerate investment in Africa

Private sector investment in Africa is driven primarily by competition between firms in China's domestic market. Increased competition during a downturn may accelerate investment in Africa. Furthermore, Chinese companies exporting to Europe and America have to adjust to falling demand by seeking new markets: already Africa has been called the 'best refuge for sunstroke prevention from the financial crisis' by the Chinese media. In a new trend, entrepreneurs also state their intention to move from low towards middle-to-high value-added products that they believe have a sustainable demand in African and other markets.

Aid flows to Africa will remain stable or may even increase. China has reiterated commitments made at the Forum on China-Africa Cooperation (FOCAC). During his recent visit to Africa, President Hu Jintao announced increased assistance and a reduction or cancellation of debts. Furthermore, Chinese aid is provided on a multi-annual line of credit of at least three years. While aid has increased significantly and may be important to some African countries, it remains small as a share of China's GDP. It is valued for associated political relationships and economic opportunities. China is therefore likely to take this chance to increase its influence in the region and secure its long-term interests.

Key messages

Ultimately, how African countries fare will be determined more by relations with their main trading partners – the US and Europe. While benefiting from their relationship with China, most countries remain more dependent on other sources of income, including remittance flows, tourism and OECD development assistance. However, during the downturn, China's continued trade, investment and aid, may act as a buffer for some economies.

If China can steer its own economy through crisis, it may become a development partner of choice with increasing 'soft power' influence in the developing world. It may appear as a steadying factor in trade and investment compared to the West.

We conclude with two key messages:

1. A multi-faceted response to Chinese state and private activities is required

Low-income countries are dealing with both Chinese state and private sectors. Private entrepreneurs are transferring part of their value chain to Africa, providing Africa with an opportunity to push up the value chain. These developments require a multi-faceted African response involving government, the private sector, unions and NGOs.

2. The development community needs to understand and work with China

The development community should take this opportunity to understand China's strategic interests and motivations to enhance collaboration in the pursuit of renewed but sustainable growth, poverty reduction and achievement of the Millennium Development Goals. The transnational dimensions of the financial crisis require a multilateral response. The development community should develop a common framework for a 'global development partnership', creating a network for bi-, tri- and multi-lateral dialogue and cooperation at various levels.

Further reading

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Credits

This *In Focus Policy Briefing* was written by Sarah Cook and Jing Gu from the Globalisation Team at IDS. The series editor is Clare Gorman. For other briefs on the crisis see: www.ids.ac.uk/go/infocus7

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