Chinese President Hu Jintao receives Argentine President Cristina Fernández de Kirchner in Beijing to sign trade deals.

TRADE

China Discovers Latin America

by Kevin P. Gallagher

Latin America was hardly on China's radar screen until the turn of the century, when the Asian giant's entry into the World Trade Organization allowed it to integrate more fully into the world economy. China's subsequent rise has created an unprecedented demand for Latin American and Caribbean goods, particularly commodities, which has helped boost the region's growth for almost a decade. Ultimately, however, such export growth may prove unsustainable. Perhaps even worse, Chinese manufactured goods are more competitive than those from Latin America in both home and world markets. These twin trends may jeopardize Latin America's prospects for long-term growth.

China's rise has stimulated Latin American exports significantly. However, at the same time, China has leapt over Latin America to become the most competitive exporter of manufactures in the world — leaving 92 percent of Latin America's manufacturing exports under threat from China in 2009. Indeed, one key (and new) finding exhibited in this brief is that China's manufacturing exports are now the most competitive in the world when measured as a share of world manufacturing exports.

Manufactures and modern services are the key to long-run growth and prosperity. While China soars ahead by such measures, Latin America seems to be returning to a primary commodity-led export path. At a deeper level, China's focus on building endogenous productive capacities has been far more effective than Latin America's "Washington Consensus" approach.

The Bright Side

China and the Latin American-Caribbean region (LAC) began to implement economic reforms within a few years of each other: China in 1978 and much of Latin

America in 1982. In 1980, the collective economic output of Latin America and the Caribbean was seven times that of China — 14 times greater on a per capita basis. Nearly 30 years later, China had pulled ahead, with a gross domestic product of $2.7 trillion in 2009 versus a pan-regional GDP of $2.6 trillion in Latin America. Over the three decades, China registered a robust annual economic growth rate of 8 percent. Latin America, in contrast, experienced a more modest 3.8 percent average annual growth rate. Between 1980 and 2009, GDP per capita increased by 6.6 percent annually in China, while in Latin America per capita GDP edged up by a mere 1.7 percent annually during years that were marked by crises and volatility.

Boom times in China have been good for Latin America, whose exports to the Asian powerhouse increased nine times between 2000 and 2009 in real terms, far outpacing the region's overall export growth, which didn't even double over the same period. In 2009, LAC exports to China reached $41.3 billion. The pre-financial crisis peak for LAC exports to China was $22.3 billion. However, this windfall was not widely shared: a handful of products account for just over 80 percent of all regional exports to China, chiefly iron, soy, crude oil and copper.

China is increasingly investing in many of these same Latin American sectors. Hard statistics are difficult to come by, but Chinese firms have invested at least $25 billion in Latin America since 2005.

The majority of this foreign direct investment (FDI) is "resource seeking." China has invested heavily in sectors that provide resources needed to meet domestic demand, including copper, oil, iron and soybeans. However, Chinese FDI is also "market seeking," in that it seeks to reach Latin American markets such as the auto and tourism sectors. Finally, some Chinese investment in Latin America is "efficiency seeking." In this case, locations in Uruguay and Mexico serve as export platforms to Brazil and the United States, respectively.

Beyond creating a hungry new market for Latin American trade and Chinese investment, China's voracious appetite has resulted in more demand and higher prices for LAC raw materials and agricultural outputs in markets around the world. From 2000 to 2007, the year before the financial crisis hit, Chinese demand accounted for 20 percent of world export growth in metals, 11 percent for copper, 55 percent for iron and 58 percent for soy. Since the crisis, while global demand for these same commodities has decreased, Chinese demand for them has doubled.

Don't Stop There

Over the longer-run future, it is hard to predict whether China will be a sustained source of demand for Latin American commodities. Even if China's appetite for LAC resources remains undiminished, the consequences may still be mixed. Demand from China could accentuate Latin America's over-reliance on commodities exports and

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Major Chinese acquisitions in Latin America have skyrocketed.
(Data courtesy of Kevin Gallagher.)

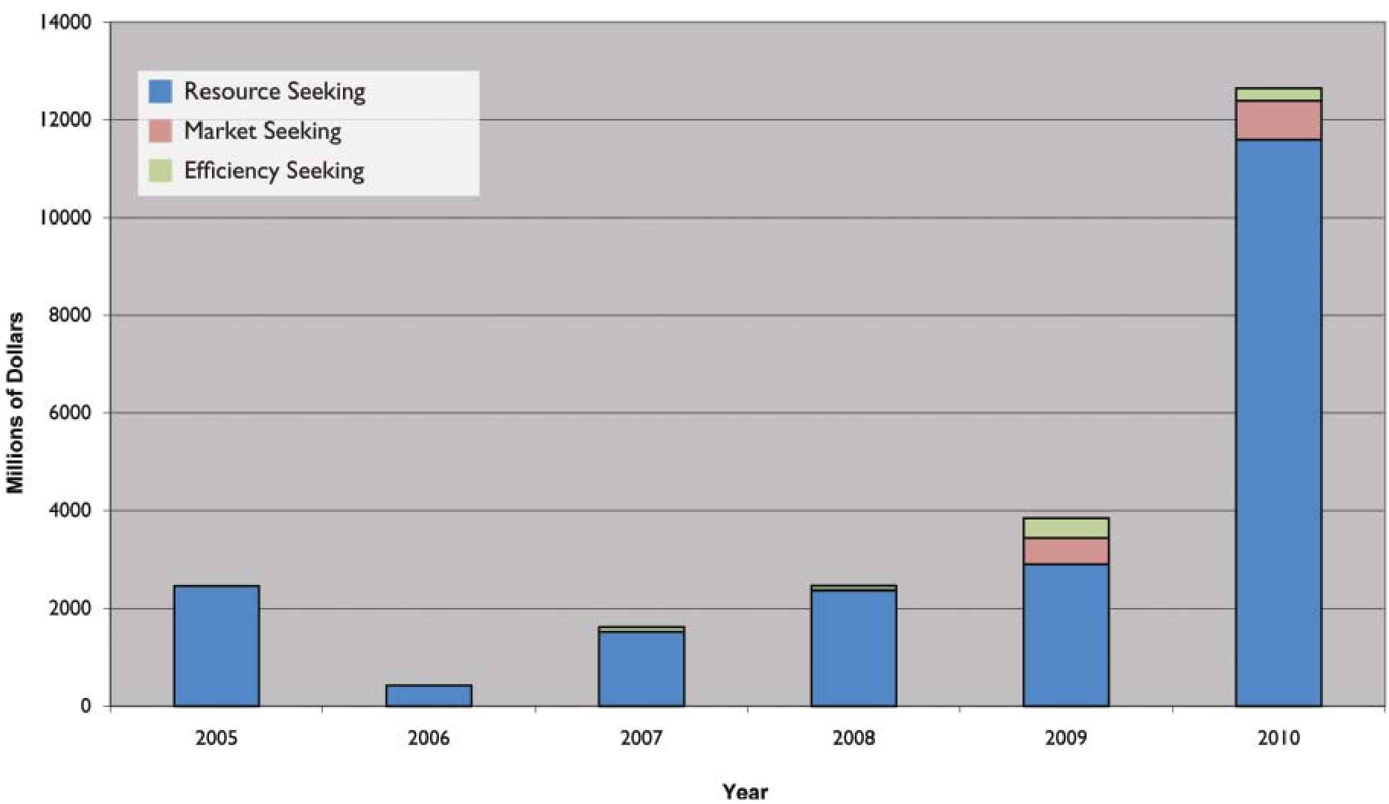


Photo by Ricardo Beliel/BrazilPhotos.

A soy plantation in the Amazon rainforest, Para State, Brazil.

jeopardize the region's ability to diversify its export basket toward manufactures and modern services. It could also drive long-lasting social and environmental change with unknown effects.

For example, between 1995 and 2009, Brazilian soy production quadrupled, due in part to demand from China — the buyer of approximately half of all Brazilian soy exports. At the same time, employment in the soy sector shrank as cultivation became highly mechanized, and some 528,000 square kilometers of Amazonian forest was cut down to accommodate expanding soy production. Such deforestation has threatened the livelihoods of many indigenous Brazilians and contributed to global climate change.

Economists also express concern that China's tug on the LAC export basket will infect the region with "Dutch disease," a common affliction among primary commodity-dependent countries. Over-dependence on commodities has been shown to lead to deindustrialization because the discovery of valuable natural resources and their subsequent export raises the value of a nation's currency, thus making its manufactured and agricultural goods, as well as its services, less competitive. This in turn eventually leads to increasing imports and decreasing exports, creating balance-of-payment problems and leading to poor economic performance.

The past few years have seen significant currency appreciation across Latin America, though it remains unclear whether such appreciation has been due to rising commodities prices or to other factors. In terms of competitiveness, however, it is fairly certain that China is outcompeting Latin America in world manufactures and services exports.

In 1980, China was not even ranked in terms of global competitiveness, but by 2009, China's manufactures had become the most competitive in the world. Argentina, Brazil and Mexico are the only Latin American nations with significant world export share, and all three have struggled to maintain competitiveness.

Nearly all of the exports from Latin America and the Caribbean are under threat from China. Those products in global or home markets where China's market share is increasing and the market share of Latin America and the Caribbean firms is decreasing are facing a "direct threat." A "partial threat" occurs when Latin American market share is increasing at a slower rate than that of China.

Between 2000 and 2009, 92 percent of Latin American manufacturing exports, representing 39 percent of the region's total exports, came under threat from China.

Mexico is the most vulnerable, with 97 percent of its manufacturing exports — which represent 71 percent of the national export base — under threat from China in 2009. With the 1994 North American Free Trade Agreement (Nafta), Mexico pinned its future to hopes that it could serve as the low-wage export platform to the United States. Mexico had a nice run, with a surge in exports to the U.S. from 1994 to 2000. Everything changed when China entered the WTO, however. Now, many of Mexico's chief export industries are hanging by a thread, particularly the textiles and apparel industries.

The electronics industry is facing the same set of problems. And it is amazing how fast the market has changed. In 2000, both China and Mexico had cornered about the same amount of the global computer market: 6 percent for China and 4.5 percent for Mexico. Yet by 2009, 47.7 percent of all the computers exported in the world came from China, while Mexico's share had dipped to 3.6 percent. In an attempt to compete with China, multinational electronics firms have resorted to cost-reduction measures such as hiring workers through global temporary worker firms: workers are hired for short-term contracts that lack most benefits and salaried wages.

Central America, one of the poorest sub-regions in Latin America, is also of particular concern. In the 1980s, most of the countries in that region established processing zones that assemble apparel for export to the United States. By 2001, such zones generated 87 percent of all Salvadoran exports to the United States, 78 percent of those from Honduras and 63 percent for both Guatemala and Nicaragua.

As recently as 2001, China and Central America were on par, with each selling about $6.5 billion worth of apparel to the United States and each holding a 12 percent share of the American apparel market. In 2004, Central American clothing exports to the U.S. had risen to $7.5 billion, while those from China, whose entry into the World Trade Organization was under way, had jumped to $10.7 billion.

In 2005, the capstone of this relationship, the Central American Free Trade Agreement (Cafta) took effect. By lowering tariffs and locking in access to the U.S. economy, Cafta was supposed to solidify Central America as a clothing hub. Instead, clothing exports from Central America plunged 25 percent from pre-Cafta days to $5.6 billion in 2009. Central America's share of American

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Copper tubes displayed for a Shanghai exhibition.

Photo by dycj-Imaginechina/Associated Press.

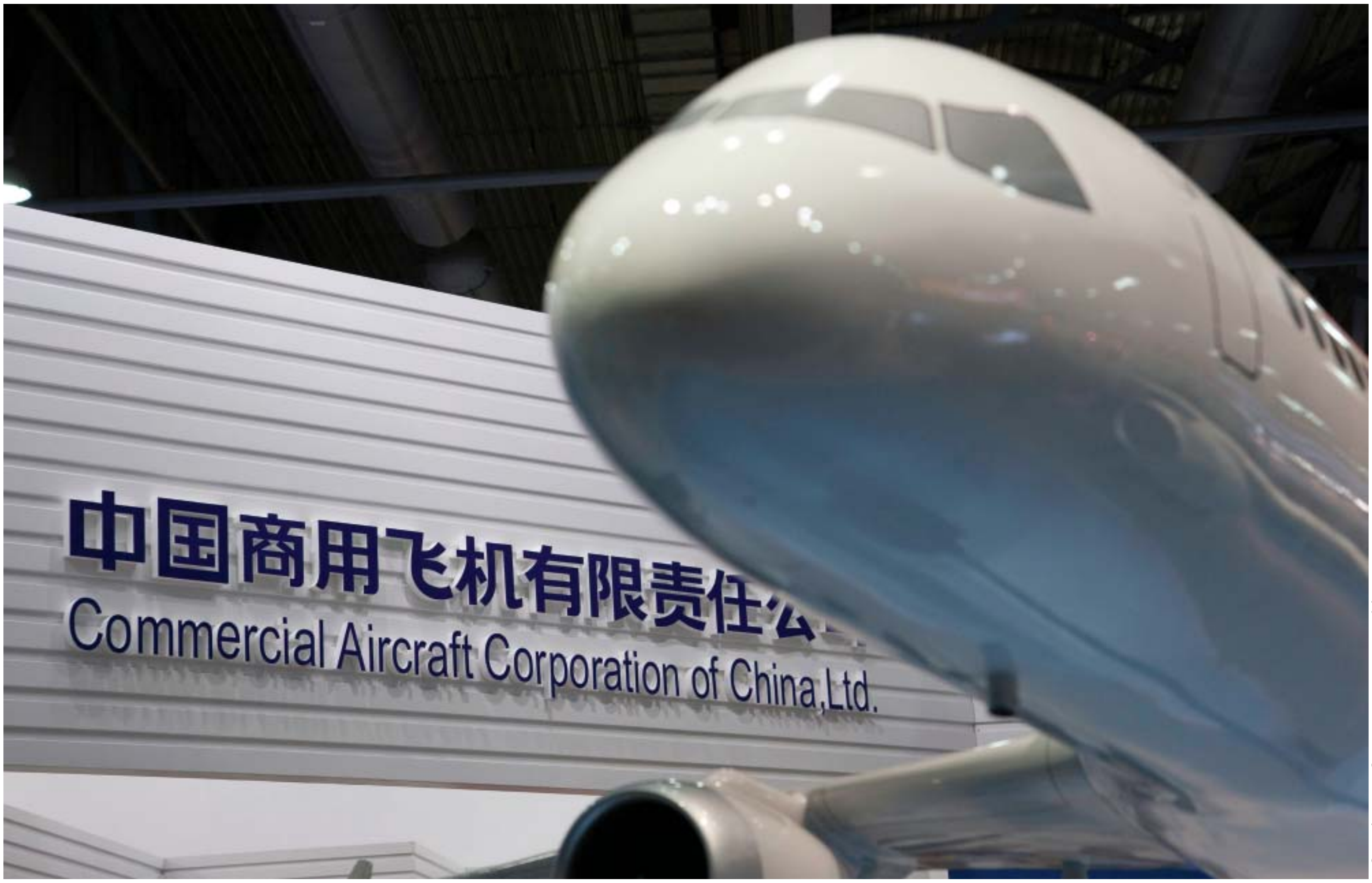

Photo by Jerome Favre/Bloomberg via Getty Images.

Commercial Aircraft Corporation of China announced orders for 100 new C919 jetliners in November 2010.

apparel imports has slipped to 8.7 percent, while China now enjoys a commanding 38 percent share.

Mexico, and to a lesser extent Central America, had a unique opportunity to enjoy almost exclusive (low-wage) access to the U.S. economy. Rather than using that window to build longer-term capabilities, such as higher value added goods, Mexico especially acted as if it would simply remain a low-wage haven for exports to the United States. China changed all that, and now Mexico struggles to stay afloat.

China as a Latin American Opportunity

These analyses should not be taken as the latest reason to blame China for another country's ills. China is not to blame. These trends are largely the result of policies put in place by Latin American countries. Many had adopted "shock therapy" or the "Washington Consensus." Governments rapidly liberalized trade and investment regimes and reduced the role of the state in economic affairs, often through privatizations that, in a number of cases, went painfully awry. China has taken a more gradual approach to integrating with world markets.

Rather than blaming China, Latin America can build on some of its own recent successes and learn from its Asian competitor in order to maximize the gains from its new economic relationship with China.

First, the additional revenue generated by exports to China and elsewhere can provide new sources of funds for stabilization and growth programs. Chile and a handful of other Latin American nations have created stabilization funds that save some of the proceeds from commodities exports for periods when prices are low or the nation needs macroeconomic stimulus. Chile's fund, which comes from copper exports, enabled that nation to put together an effective stimulus package in response to the financial crisis.

There is no reason why such funds need only be earmarked toward macroeconomic stabilization. Revenue from commodities exports could also be used to invest in environmental programs to mitigate the negative effects of commodity-driven growth and, perhaps most importantly, in programs to boost industrial competitiveness.

It is in terms of industrial competitiveness that Latin America can learn the most from China. That country's path to integration with world markets has been gradual and strategic, whereas most Latin American nations rapidly relinquished the role of the state in economic affairs. While China may not be an ideal model for development given its autocratic state, it certainly should be a motivator for nations with manufacturing capabilities to think hard about competitiveness and upgrading.

Even though Latin America and China began their reforms at roughly the same time, their motivations for reform were quite different. Whereas Latin American reform began around 1982 as a reaction to the collapse in oil prices, Chinese economic reforms began in 1978, two years after the death of Mao Zedong and the end of the Cultural Revolution, as the country began to cautiously reopen to the world. In that year, China embarked on a program of economic reform aimed at strategic integration into the world economy by following a "dual track" policy. The policy consisted of liberalizing FDI and inflow of imported inputs to selected industries, while at the same time buttressing those sectors to the point of maturity and nurturing other sectors until they were ready to face competition with imports.

China's industrial strategy has been three-pronged. First, government policy has focused on creating endogenous productive capacity by targeting specific industries through state-owned enterprises (SOEs) or government support, paying increasing attention to science and technology policy and linking the SOEs with the private sector and research institutes. Secondly, and very importantly, Chinese support for domestic industry has always had an eye on foreign markets: China has gradually and strategically integrated into world markets in order to gain access to technology and finance. Thirdly, in undertaking economic reform, China's new leaders have taken an experimental approach, using the market and trade as a means to development. Hence, in the eyes of Chinese policy makers, the market and government policies should complement one another, while the weight of each should be allowed to change as the economy develops.

Such an approach stands in stark contrast to Latin America. The region experimented with industrial policy during its Import-Substituting Industrialization period (roughly 1940 to 1980). The approach was a modest success at best. The policy did help industrialize nations like Brazil, Mexico, Argentina and others in the region. Yet, with a few exceptions, the firms within those industries were extremely inefficient by global standards because there was too much focus on domestic markets. In addition, Latin American industrial policy was financed largely by debt, as opposed to export revenue and savings in the Chinese case. By the time LAC countries began their economic reforms in the early 1980s, dissatisfaction with the import substitution model had led to skepticism about any government intervention in the economy. There was an abrupt transition to free trade and market-based economies, which were seen largely as ends in themselves: it was taken for granted that free markets would lead inevitably to enhanced learning through trade, the deepening of industrialization and growth.

Both import substitution and unfettered free markets have proved less than ideal paths for Latin American and Caribbean development. Chinese investment in Latin America could be an opportunity for LAC countries to undertake new development strategies. Increased export revenue could be used to invigorate and expand stabilization funds and provide the capital for an innovative approach to industrialization. There are some signs that this is taking place. As previously mentioned, Chile's stabilization fund allowed it to weather the global economic downturn. Brazil has also begun to take industrialization and modern services seriously again, particularly through its national development bank.

A business-as-usual approach, on the other hand, could be dangerous. Over-reliance on primary commodities could cause macroeconomic, employment and environmental problems in the longer term. What's more, China is already swiftly out-competing Latin America in world manufacturing markets. As China has shown, nations can conduct economic reforms to great benefit. Latin America should follow suit.

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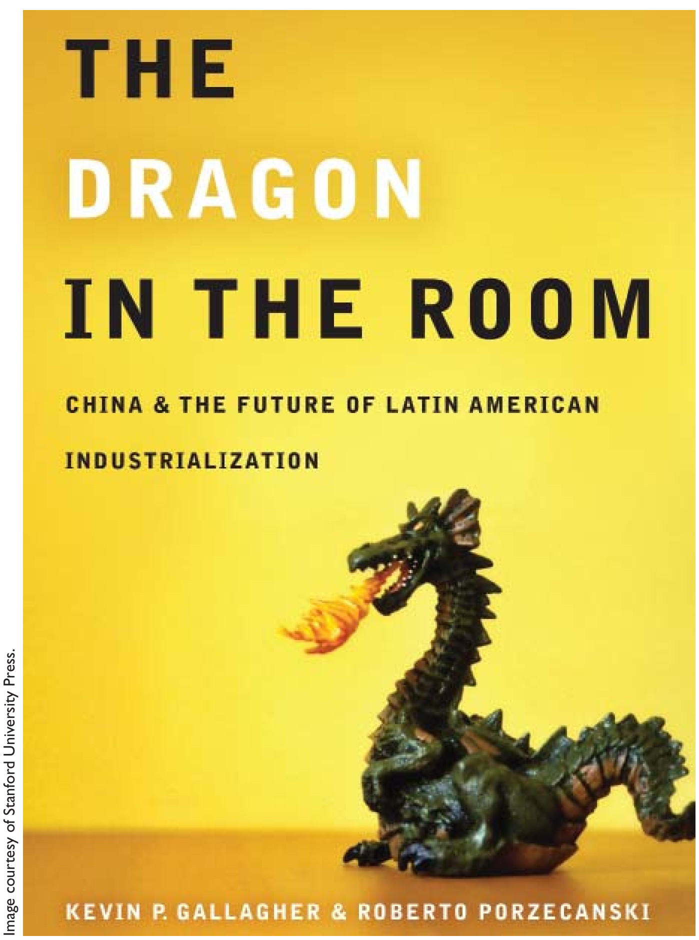

Image courtesy of Stanford University Press.