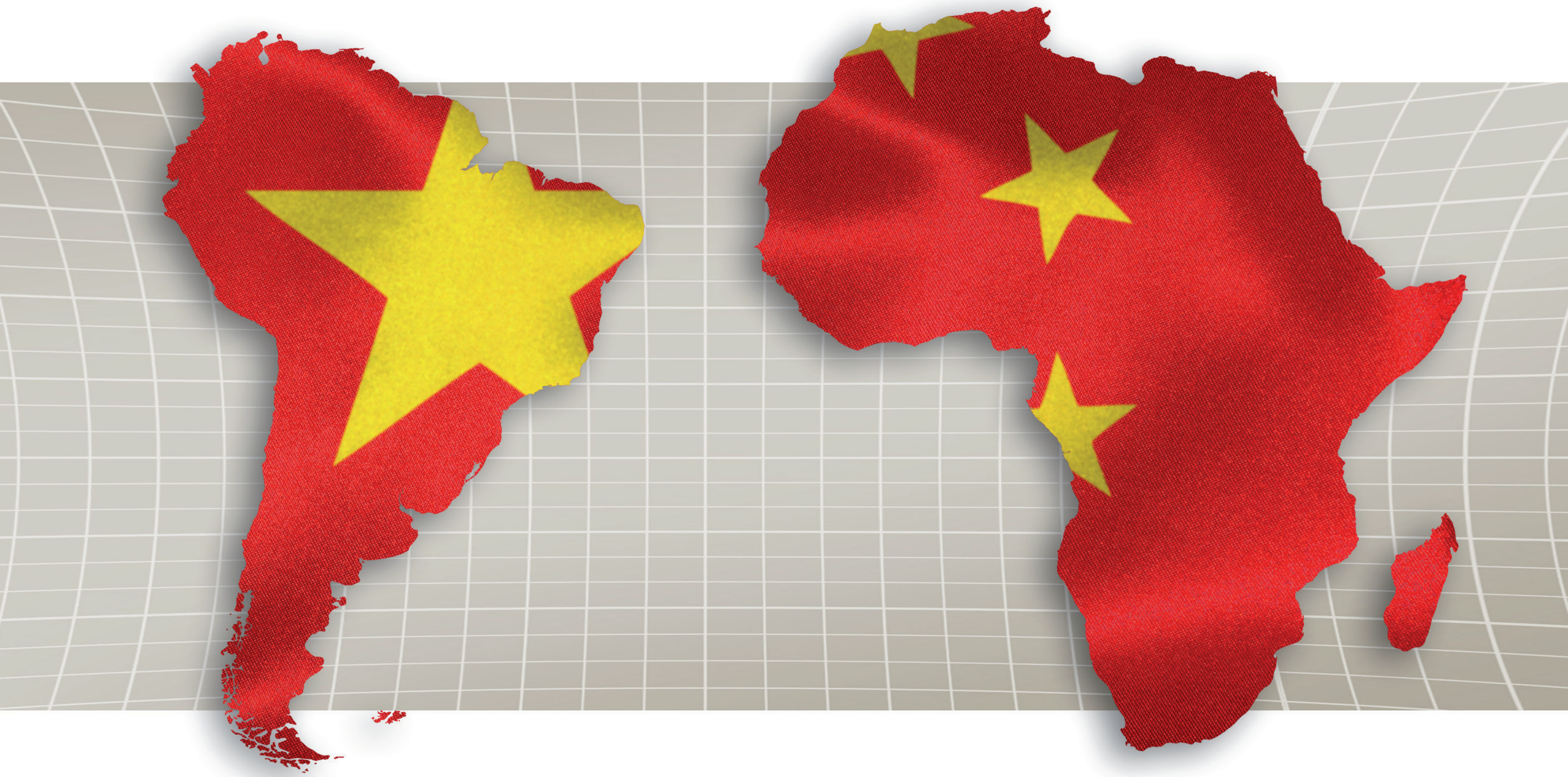
The Economist Intelligence Unit

The evolving role of China in Africa and Latin America

A report by The Economist Intelligence Unit



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Report highlights

- China continues to play a pivotal role in both Africa and Latin America as a trade partner, investment facilitator and financial backer, but there are big questions over how this relationship will evolve in the years ahead in view of instability and uncertainty caused by China's economic rebalancing act.
- In Africa, China is adopting a more interventionist stance in its dealings to protect its commercial interests, strengthening its trade ties across a wider range of product markets, investing further in strategic supply bases, and pushing ahead with trade- and investment-facilitating finance initiatives.
- Chinese firms remain engaged in Africa and are positioning to snap up extractive sector investments at lower prices, with a view to securing longer-term strategic supplies. This is already taking place in Copper-belt countries such as Zambia, the Democratic Republic of Congo (DRC) and Congo (Brazzaville).
- Chinese firms are well-placed financially, and strategically connected to tap into growing demand from Africa's low-income masses, as well as exploit growing demand from parts of the urbanised upper-low to lower-middle income segments of Africa.
- Trade and investment by China into Africa will seek to consolidate its presence on the continent, tap into its fast-growing consumer markets, establish production bases closer to its end clients, exploit Africa's free-trade deals (among regional economic communities and with major international partners), and set up production bases to feed value chains and consumer markets back in China.
- In Latin America and the Caribbean, the direct impact of weaker demand from China, and its indirect effect in the form of lower commodity prices, has forced difficult policy adjustments, particularly for South America's commodity exporters, which are still ongoing. The Economist Intelligence Unit projects a contraction in regional GDP of 0.3% in 2016.
- Partly in response to concerns of policymakers there to the problem of a growing trade deficit, China has attempted to reboot its relations with Latin America, focusing on investment and technical co-operation, in an increasingly diverse number of sectors that have the potential to improve infrastructure, boost research and development (R&D), and raise the region's long-term growth rate.
- The expected convergence of Chinese incomes with Latin American per head incomes should also help the region to make some competitiveness gains going forwards, particularly in areas in which it has comparative advantages, such as agribusiness, with the potential to rebalance trade relationships.
- For Latin America to take full advantage of these opportunities, productivity-enhancing reforms and improved intra-regional trade will be necessary in the coming years.

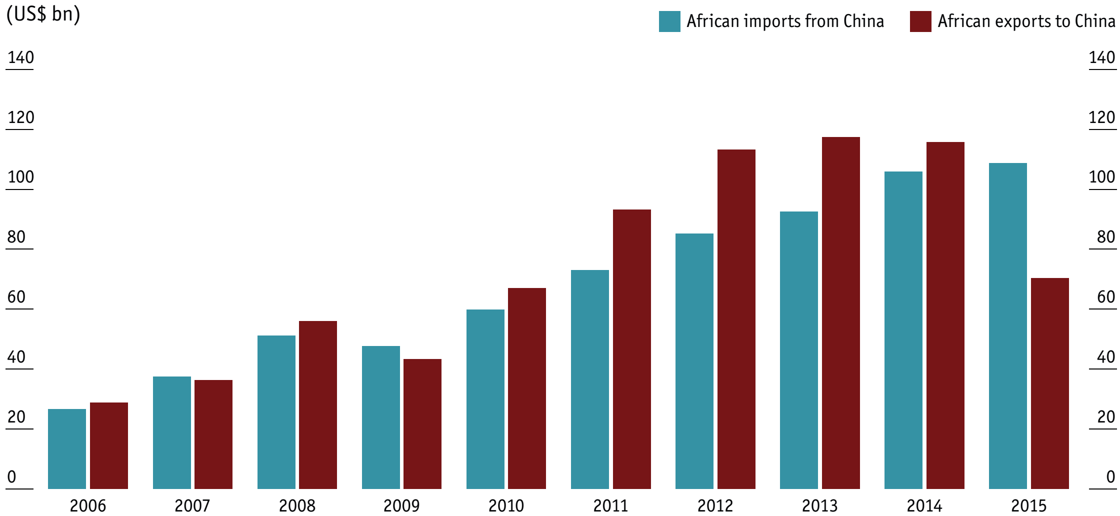
The evolving role of China in Africa

Introduction

China's presence in Africa is not new, but its interaction with African states is evolving rapidly and bringing with it fresh challenges and opportunities for the region's leaders and business enterprises, and foreign firms with an interest on the continent. China is adopting a more interventionist stance in its dealings with Africa to protect its commercial interests, strengthening its trade ties across a wider range of product markets, investing further in strategic supply bases and pushing ahead with trade- and investment-facilitating finance initiatives. China appears committed to African ventures and it is reasonable to expect that its presence will get much bigger, deeper and more varied as it moves through into a new phase of competition for African markets and supplies.

Staying the course on commodities

African trade with China



Sources: UNCTAD; National Bureau of Statistics of China.

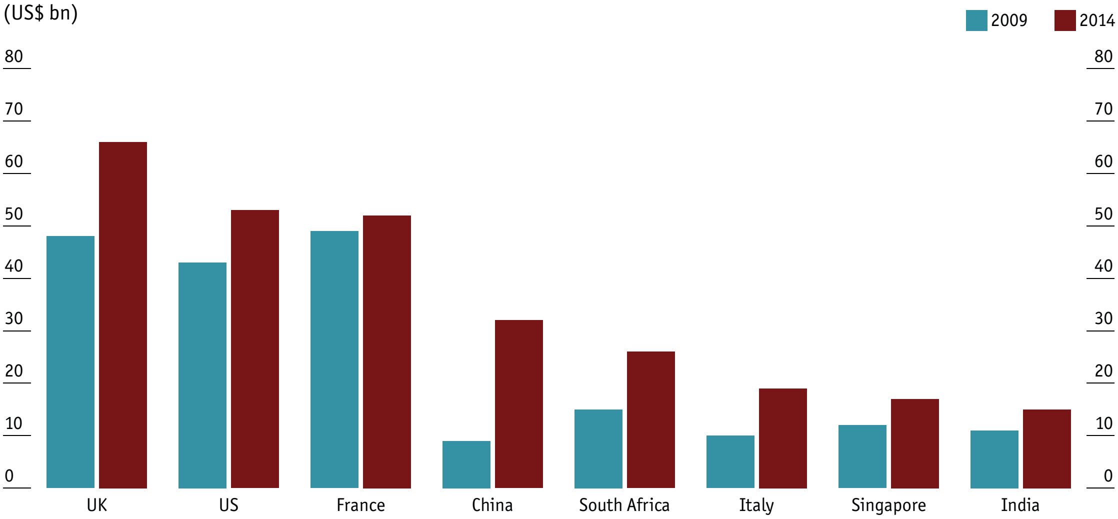
China is Africa's single biggest trade partner following years of stellar growth since the early 2000s, which reflected China's insatiable appetite for Africa's energy products and raw materials, as well as its ability to place a wide range of goods on the African continent. China and Africa exchanged more than US$210bn worth of goods a year in 2013 and 2014, although trade flows have taken a hit in recent years on the back of much lower energy and solid mineral export revenue. Africa's exports to China dropped by almost 40% in current US dollars in 2015, and the slide continued in the first half of 2016 with a fall of just over 20% year on year. The anticipated Chinese economic slowdown over the next five years, coupled with efforts to rebalance the economy away from investment and towards consumption, is expected to curtail China's import demand for commodities and restrict its capacity to invest in and lend to some African states. This maturing of the Chinese economy raises big questions about the exposure of Africa's major commodity exporters to China and their structural weaknesses, future financial stability and potential creditworthiness in the short to medium term. However, the commodity downturn will not last forever. Chinese firms remain engaged and are positioning themselves to snap up extractive sector investments at lower prices with a view to securing longer-term strategic supplies. This is already taking place in Copperbelt countries such as Zambia, the Democratic Republic of Congo (DRC) and Congo (Brazzaville).

Penetrating low-cost markets

Africa's imports from China have held up much better than exports, although the pace of growth slowed sharply in 2015 and sales contracted by around 12% year on year during the first half of 2016. Currently, China takes almost 20% of total African imports and has penetration rates at elevated levels for many countries. China will continue to have success in linking the sale of plant, machinery and materials to ongoing and future large-scale investments in natural resource extraction and infrastructure projects across Africa. More importantly, the ability of Chinese firms to sell a wide range of low-cost and competitively priced manufactured goods (including clothing, footwear, furniture, cosmetics, household plastics, beverages, electronic goods, mobile phones, automobile parts, intermediate goods and pharmaceuticals among others) will remain strong in Africa. Chinese firms are well-placed financially and strategically connected to tap into growing demand from Africa's low-income masses, as well as to exploit growing demand from parts of the urbanised upper-low to lower-middle income segments of Africa. More challenging economic times in many African states could create additional demand for the type of low-cost products China is adept at marketing, and at a time when the slowdown in China increases the need for its firms to look overseas for product placement, a strategy also encouraged by the Chinese government. Much stiffer competition from China in low-cost products, including a potential increase in informal trade flows and counterfeit goods, will pose an increasingly serious challenge to local and international firms in Africa.

FDI stocks in Africa

(US$ bn)

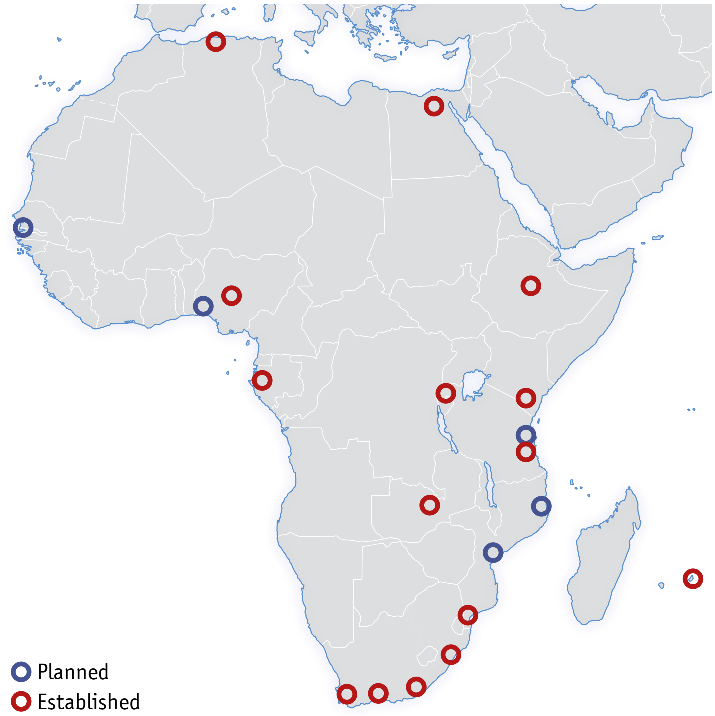


Source: UNCTAD.

Building up and branching out

The Chinese president, Xi Jinping, addressed the Forum on China-Africa Co-operation at the end of 2015 by highlighting China's strong investment outlays in Africa to date and indicating that China's future focus on Africa will pay specific attention to encouraging industrialisation, fostering agricultural modernisation, building essential infrastructure and enhancing its trade and investment facilitation. There are various commercial strategies that lie behind this vision, which include aims to consolidate China's presence on the continent, tap into its fast-growing consumer markets, establish production bases closer to its end clients, exploit Africa's free-trade deals (among regional economic communities and with major international partners) and set up production bases to feed value chains and consumer markets back in China.

Major special economic zones in Africa



Source: The Economist Intelligence Unit.

The creation and development of special economic zones is a key feature of China's strategy that addresses some of its longer-term aims. In particular, China has been active in sharing its experiences in industrial development and intends to invest further in local production and trade-facilitating industrial infrastructure. Crucially, Chinese investment in export-oriented activities should help African exports to China become much more diverse, as intermediate and finished products take up a greater share of the export mix. China's push for African production bases, together with improving logistics connections in Africa and with China, and the ongoing rebalancing of the Chinese economy (away from investment to consumption) should reinforce this diversification trend in the years ahead and create new opportunities for firms based in Africa.

Trade finance and facilitation

To support China's longer-term interaction with Africa, Mr Xi also announced last December that China would make US$60bn of finance available (including interest-free loans, preferential loan and export credit schemes, and new working capital for Africa-focused development funds), although how much of this actually materialises remains to be seen. However, one trade-facilitating initiative that is already well under way involves the internationalisation of the renminbi. China is increasingly using its

own currency to finance trade deals around the world and African states are eager to get on board. In April Nigeria joined a growing list of African countries that allow the renminbi to flow freely through their banking systems and form part of their foreign-exchange reserves. These agreements aim to help ease pressure on stretched African finances, reduce transaction costs and exchange losses, offer some protection against rising commercial default risk and ultimately facilitate trade and investment between Africa and China. Countries such as South Africa, Nigeria, Angola, Ghana, Mauritius, Zimbabwe and others are likely to be joined by many more over the next five years in entering into renminbi swap agreements and cementing the role of the renminbi on the African continent as a medium of exchange and project finance.

Protecting its interests

Finally, China has a reputation for taking a non-interventionist and hands-off approach to national politics and security situations in Africa, and simply trading with or investing in countries based on commercial principles rather than political persuasion or governance performance. However, this position is changing and China seems intent on taking a more interventionist stance in future. A key driver of China's change in policy towards Africa is a desire to protect its commercial interests on the continent and build its reputation as a global citizen. On the commercial front, China is committed to growing its already wide range of investments, trade routes and business connections in Africa and recognises that these could benefit greatly from a stronger security presence and greater political influence in Africa.

China has had its fingers burnt in African states such as Libya, Chad, the Central African Republic, the DRC and Sierra Leone, and intends to avoid a repetition of financial losses and hurried evacuations. China has an increasing number of combat forces and peacekeepers in Africa and is involved in peacekeeping efforts in places such as Sudan, South Sudan, Mali, the Central African Republic, the DRC and Liberia. In addition, the Chinese navy is operational off the Horn of Africa and its presence will grow and extend in the years ahead as part of an "open seas" policy. In a statement of intent, China is in the process of establishing its first naval base in Africa in Djibouti to protect current and future trade routes, including the long-term development of a "maritime silk route" connecting Asia with the Middle East, Africa and Europe. More bases could soon follow, with potential candidates found in Mombasa, Dar es Salaam, Walvis Bay, Luanda and Lagos, and in the meantime the Chinese navy will continue with a charm offensive around the continent.

Latin America and China: Shaping the new normal

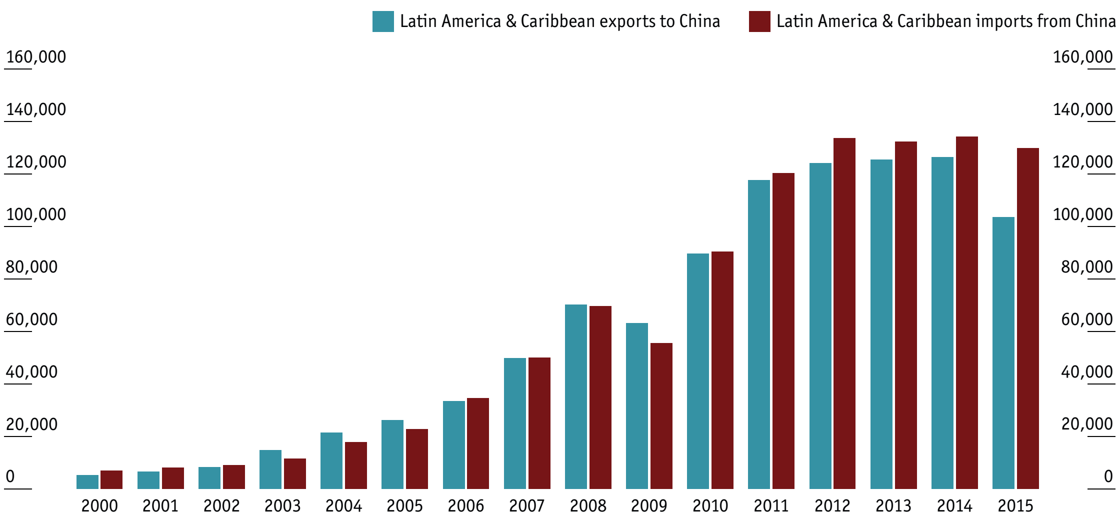
Introduction

China's role as a trade and investment partner, and as a source of financing for Latin America and the Caribbean, has grown dramatically over the past decade. China's slowdown, which has weakened import demand growth and contributed to a sharp fall in global commodity prices, therefore raises important questions about economic relations between China and Latin America going forwards. Latin America's own deep adjustment to the end of the commodity boom has exposed a continued dependence in much of the region on a narrow, capital-intensive, commodity-based export basket. This has highlighted a need for export diversification and for a move up the global value chain, all with a view to raising long-term growth rates and reducing Latin America's high level of income inequality. China's recent engagement with Latin America suggests a recognition of these challenges and a desire to reboot relations with the region in a mutually beneficial fashion. However, successful implementation will also require progress on structural reform and on deepening intra-regional trade by Latin American governments in the coming years.

Deepening links...

In the past 15 years trade between China and Latin America has grown almost twentyfold. From around US$5bn in 2000, Latin America's exports to China totalled US$104bn in 2015. Inflows of foreign direct investment (FDI) from China into Latin America and the Caribbean were slower to take off but have also risen markedly, from a low base, in the past five years. According to the Heritage Foundation, a US think-tank, Chinese FDI into Latin America totalled US$84bn between 2010 and 2015. Similarly, statistics from the Inter-American Dialogue's *China-Latin America Finance Database* show finance by

Trade flows

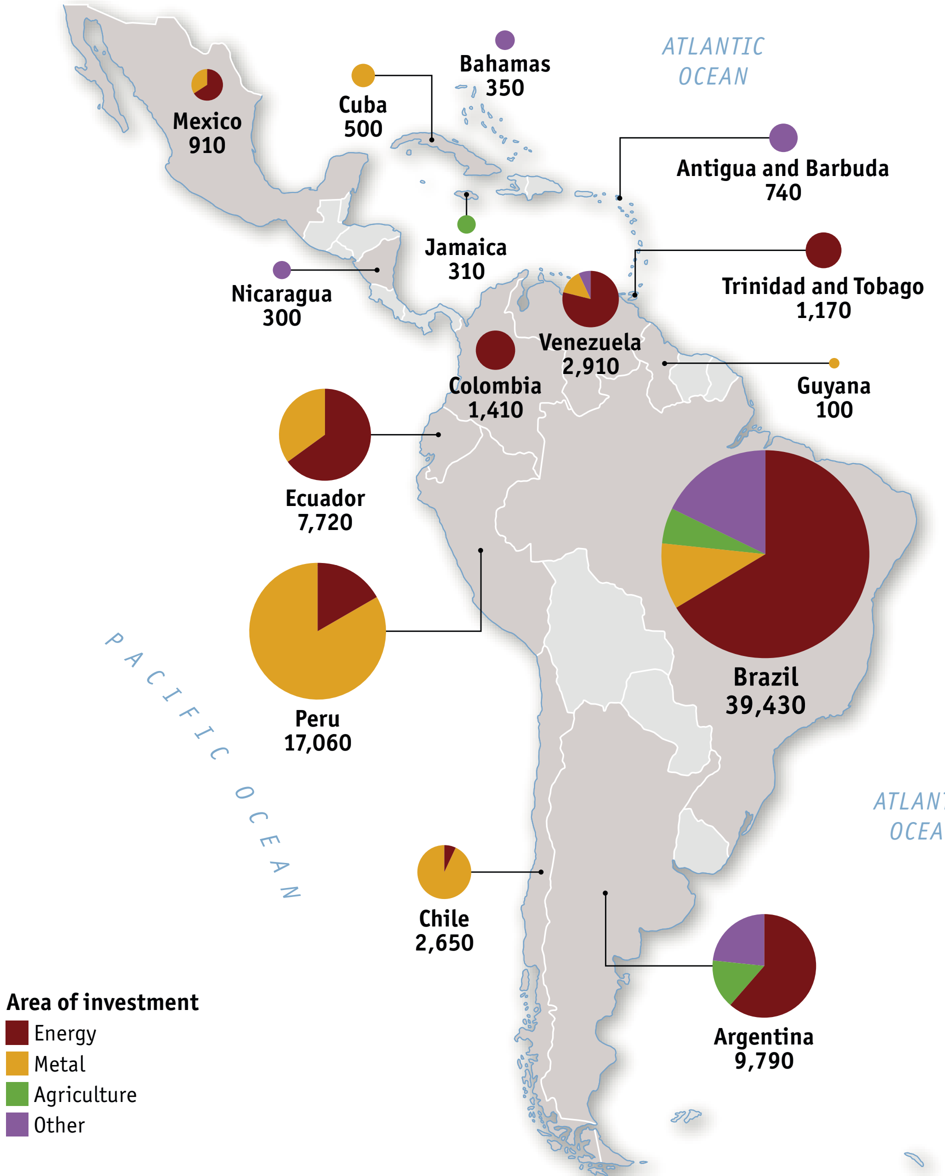


Source: IMF, Direction of Trade Statistics.

the China Development Bank (CDB) and the China Export-Import Bank (Ex-Im Bank) to Latin America and the Caribbean rising sharply in the past five years, to a total of US$104bn in 2010-15.

Increased trade, investment and financing flows from China have undoubtedly had a beneficial impact in the form of increased growth in the past decade. But they have also left the region vulnerable to the inevitable slowdown and rebalancing of China's economy that has occurred over the past two years, which has seen a sharp adjustment in China's demand for imports and in global commodity prices. The data are stark; according to The Economist Intelligence Unit's estimates, growth in volumes

FDI flows from China to Latin America and the Caribbean, 2005-15
(US$ m)



Sources: American Enterprise Institute; Heritage Foundation.

of goods and services imports fell from 9.2% in 2014 to 1.6% in 2015. In US dollar terms, China's imports from Latin America fell by almost 20%, to US$103bn, from an all-time peak of US$126bn a year before. The direct impact of weaker demand growth from China, and its indirect effect on Latin America in the form of lower commodity prices, has forced difficult policy adjustments, particularly for South America's commodity exporters, that are still ongoing. On aggregate, the region's fiscal revenue has fallen by 4% of GDP in the past five years, driving the public debt/GDP ratio back up above 50% and necessitating a substantial tightening of fiscal policy in all of Latin America's large economies. Combined with a retrenchment in investment across the region, and its knock-on impact on private consumption, the result has been two extremely disappointing years for the economy: in 2015 real GDP grew by just 0.1%; in 2016 The Economist Intelligence Unit projects that it will contract by 0.3%.

...and deepening imbalances

The region's economic woes are at least partly the reflection of a failure by policymakers to take advantage of the commodity supercycle of the past decade to implement domestic structural reforms that could set the stage for more diversified, competitive and productive economies. But a closer look at the data highlights elements of the trade and investment relationship between China and Latin America that are problematic. Figures from the UN Economic Commission for Latin America and the Caribbean (ECLAC) indicate that around three-quarters of the region's exports to China are made up of just four commodities: oil, copper, iron ore and soybeans. Meanwhile, reflecting Latin America's relatively high per head incomes (particularly vis à vis Africa), along with China's low production costs, China exports a high proportion of low- and high-tech consumer goods to Latin America. This process of exporting natural resources to China and importing higher-value added manufactures has produced large and growing trade deficits for most of the past decade. Weak commodity prices in 2015 amplified this trend, causing Latin America's trade deficit with China to quadruple, to US$26bn. A similar pattern is evident in China's financing and investment role in the region, which has been centred either directly on natural resource industries in order to secure supply, or on associated infrastructure to facilitate transport.

Latin America's economic slowdown, which has coincided with a shift in political stance in some large economies in the region from the left to the right of the political spectrum, has also raised questions over China's stance on lending. In particular, Venezuela's deepening economic crisis—the result of years of policy mismanagement exposed by falling oil prices—has raised doubts over its capacity to pay and over China's largesse during the past five years. According to the Heritage Foundation, the CDB and China Ex-Im Bank have lent Venezuela US$65bn over the past decade—representing almost 15% of Venezuela's GDP (even at the country's highly overvalued official exchange rate)—over half of all Chinese lending to Latin America and the Caribbean in the period. Even in 2015, amid market concerns over an eventual default by Venezuela, US$10bn in loans were extended by China to the country. In 2016, amid economic and political turmoil in Venezuela, fresh disbursements by China have now ground to a halt, and the knock-on effect on future lending policy to Latin America could be substantial, involving tighter credit conditions and a rethinking of conditions, which have to date (publicly at least) been absent.

Beyond the Silk Road: a plan for Latin America

Policymakers in China and Latin America are clearly aware of the challenges posed by the structure of trade and investment between the two partners. During a May 2015 visit to Latin America, China's premier, Li Keqiang, noted that "from a long-term point of view, Latin America should not limit itself to being a 'global supplier' of primary products, nor China being a 'world factory' of cheap products forever". Moreover, as China has embarked on its own long-term plan for the rebalancing of its economy towards consumption, it has presented its own set of principles for engagement with Latin America. Latin America has not been a beneficiary of the Chinese government's grand "One Belt One Road" infrastructure project involving China's closer neighbours in Eurasia and North Africa. But a new framework for future relations with Latin America was outlined in 2014, during the visit of China's president, Xi Jinping, and was subsequently refined in 2015 during a visit by Mr Li.

The so called 1+3+6 Plan outlined by Mr Xi entails one plan (the 2015-19 China–Community of Latin American States Co-operation Plan) with three engines (trade, investment and finance), and six priority sectors for co-operation (energy and resources, infrastructure construction, agriculture, manufacturing, scientific and technological innovation, and IT). A new formula was added to the mix a year later, when Mr Li outlined the so called 3x3 Plan during his visit to the region. The latter sets out three priorities for the development of integrated infrastructure networks in Latin America (IT, electric power and logistics), and emphasises the three key actors in the engagement process as government, society and the private sector.

If implemented to their full potential, the plans, which set out to increase trade and investment dramatically while at the same time altering the composition of both countries' exports, could have transformative effects for Latin America. Importantly, China has placed a fresh emphasis on the role to be played by business. Until now the presence of private Chinese enterprise has been extremely limited, reflecting the dominance of China's state-owned enterprises in key natural resource sectors, while outward FDI into China has been practically non-existent (with a few noteworthy exceptions such as Brazil's Embraer). This has not only limited the possibility of technology transfer, but hindered the deepening of business links and the diversification of exports.

3 x 3: a plan for Latam-China relations

Infrastructure channels	Actors	Forms of finance
Logistics	Government	Investment
Energy	Society	Credit
Information Technology	Companies	Insurance

Latin America's export diversification will, in theory, also be boosted by the shift in emphasis away from natural resources (although these will continue to dominate the export basket), just as China's domestic economic growth drivers shift away from low-cost manufacturing towards services. In areas highlighted by the China-Celac plan, Latin America has clear deficiencies that fresh investment by China would go some way to addressing. At just over 2% of GDP investment in infrastructure by Latin America and the Caribbean is currently low, both by comparison with the rest of the world and relative to its needs: ECLAC estimates that, in order for the region's infrastructure network to meet projected demands and not become a constraint on long-term growth, more than 6% of GDP should be invested in infrastructure in 2016-20. Foreign investment is sorely needed to bridge this gap, given the region's public spending constraints.

In research and development (R&D), Latin America also lags and would benefit immensely not only from FDI into higher-tech industry by Chinese firms, but by associated technology transfer and experience of China's successful drive to increase innovation and educational outcomes. At present, Latin America's investment in R&D is estimated at just 0.5% of GDP, well below the global average of over 2% of GDP. China also invested just 0.5% of GDP in R&D in the mid-1990s, but has since overseen a steady increase, to 2% of GDP currently.

Another sector identified by the China-Celac plan with huge potential for an increase in mutually beneficial trade and investment is agribusiness, given China's growing consumption demands and Latin America's comparative advantages in agricultural production. To date, although agricultural exports have risen rapidly, they remain centred around primary, unprocessed commodities, particularly soybeans, and the opportunity for Latin America to produce and export higher value-added processed goods amid a declining gap in unit labour costs between the two regions is clear.

A challenging reform agenda

Successful implementation of the plan will depend to a substantial degree on China's own economic transition and its capacity to follow through with stated commitments. But quite apart from the question of China's commitment and capacity to stick with its plan for engagement with Latin America (which have sometimes been lacking in the past), improvements will depend on the ability of Latin America policymakers to raise the competitiveness of their continent's output via a comprehensive—and politically difficult—programme for structural reform. China has noted for example, that it is ready to sign more free-trade agreements (FTAs) with the region—currently only Chile, Peru and Costa Rica have FTAs in place with China—to deepen business links, but that governments need to work to improve service efficiency, bring down business costs and create an enabling business environment for companies, tasks which will require politically difficult reforms to tax and regulatory systems, and the labour market. An upgrading of the regulatory frameworks for public-private partnerships (PPPs)—including a review of weak incentive structures and uncertain returns on investment—and a scrapping of restrictions on private investment in some areas will also be crucial. Furthermore, improving education outcomes, where Latin America lags behind, will remain a key challenge of domestic policymakers in order to raise value-added and per-head incomes.

In this regard, and while the challenges and opportunities represented by China remain large, the actions of Latin America's own policymakers—and the region's ability to shape the "new normal" of a slowing China into an era of productivity-enhancing reforms—will determine its long-term growth path. Our own forecasts, which see regional growth recovering to 1.9% in 2017 and to 3.1% by 2020, imply some cautious optimism about the ability of policymakers to drive forward with reforms and take advantage of the opportunities presented by China's economic rebalancing.

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