Capitalizing on the China Cycle: Time is Running out for Latin America

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In Latin America and the Caribbean (LAC), as in many other parts of the world, there is much concern about changes in the Chinese economy. The China boom from 2000 to 2011 was very good to the world in terms of trade and growth, and Latin America was no exception. China registered impressive growth at 9.2 percent in 2011, but that growth has since slipped to the 7 percent range, where it will remain for the foreseeable future. This slowdown is causing anxiety throughout the world, including in LAC.

Indeed, sluggish Chinese demand will put a drag on LAC growth in the short term. But the medium- and longer-run prospects depend on public policy in both China and Latin America. If China manages to re-balance its economy, there is potential for steady imports from LAC. However, it will be up to LAC to put in place appropriate institutions to channel the benefits of Chinese trade and investment toward longer-range development.

In June of 2012, Chinese Premier Wen Jiabao proposed a multibillion-dollar collaboration with the region in manufacturing and agriculture—a major, positive step for both China and LAC. The question now is whether LAC will rise to the challenge. The region's ability to implement much-needed economic and institutional reform may be of far graver concern than China's ability to post high rates of growth.

Latin America's China Boom

After China entered the World Trade Organization (WTO) in 2001, it experienced major gains in economic growth, per-capita income over 9 percent annually, and poverty reduction. China's opening to the world economy and its focus on state-led urbanization, infrastructure, and industrial policy transformed the country into a net importer of food and minerals for the first time in its history (Ferchen, 2011; IDB-ADB, 2012).

LAC subsequently underwent its own boom in trade with China. In 2000, LAC exported $4.2 billion in goods (in 2005 dollars) to China. By 2011, however, LAC exports to China had increased almost 18 times to $75 billion, accounting for from 1 to over 11 percent of LAC trade. Many nations such as Brazil and Chile now count China as their number one export destination. LAC has also been a major destination for Chinese investment, attracting approximately $30 billion in foreign direct investment between 2000 and 2011 and $80 billion in Chinese policy bank loans to Latin American governments (see Rosales and Kuwayama, 2011; Gallagher et al, 2011). The majority of trade and investment takes place in South America's primary commodities sectors, namely iron ore, soybeans and oils, copper, and petroleum in Argentina, Brazil, Chile, Colombia, Peru, and elsewhere.

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FOREWORD

The Inter-American Dialogue is pleased to publish this issue brief prepared by Kevin Gallagher, associate professor of international relations at Boston University and co-author of *The Dragon in the Room: China and the Future of Latin American Industrialization*. An expert on economic development and trade and investment policy, Gallagher has written extensively on the economic relations between China and Latin America. Gallagher's report, "The New Banks in Town: Chinese Finance in Latin America," published by the Inter-American Dialogue in 2012, provided the first comprehensive summary of China's lending practices in Latin America and the Caribbean.

This paper on commodities-related trends in Latin America is the second in a series of economics briefs that will be published by the Inter-American Dialogue's China and Latin America program in coming months. China's slowing growth, its proposed "economic transformation," and its commitment to deeper economic integration with Latin America are changing the landscape of Sino-Latin economic engagement. Latin American nations, meanwhile, have adopted strikingly different approaches to managing China's expanding economic influence in the region. The Dialogue's China and Latin America economics briefs will address areas of emerging interest at this pivotal moment in China-Latin America economic relations. The first brief in this series, "China's Free Trade Agreements in South America" by Carol Wise, was published in November. Going forward, our contributors will address such topics as China's approaches to *renminbi* internationalization in Latin America, China Development Bank policy, and China's influence on Latin American industrial policy. We are pleased to recognize Open Society Foundations for its assistance in publishing this and forthcoming China and Latin America economics briefs.

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Chinese trade and investment have made Latin American commodities relatively scarcer in global markets, contributing (in part) to an overall increase in their prices. From 2000 to 2011, the growth of Chinese imports of LAC's 16 largest commodity sectors accounted for 50 percent of global growth in those sectors—181 percent in the world iron ore market, 96 percent of pulp and paper growth, 74 percent of import growth, and 40 percent of copper growth.[1]

[1] A percentage can exceed 100 because I calculate the change in Chinese import demand divided by the change in world exports. Chinese imports could never exceed world exports but, in some cases, the growth in Chinese exports exceeds the growth in world exports because of a reduction of imports from other markets. Indeed, if one examines such calculations made for the period 2006 to 2011, Chinese import growth as a share of world export growth was 263 percent for copper and 235 percent for iron ore.

Rhys Jenkins (2011) estimates that between 2002 and 2007, iron ore prices went up 184 percent, copper 356 percent, and soybeans 80 percent. Chinese demand alone does not explain these increases, of course. In the wake of the global financial crisis, commodities have been the source of heightened speculation and of real investment. In measuring how much higher the world price for a particular commodity was in 2007 than it would have been if Chinese demand rose (from 2002 to 2007) at the same rate as in the rest of the world, Jenkins calculates a "China effect." According to his calculation, Chinese demand accounted for at least a doubling of the world price for iron ore, a 50 percent increase for copper, and 5 to 10 percent price hike for soybeans and soybean oil.

China trade and investment contributed to LAC's best per-capita growth in decades. From the early 1980s to the turn of the century, LAC was affected by financial crises and the policies of the Washington Consensus, barely meeting 1 percent annual per-capita GDP growth. Between 2002 and 2007, however, LAC per-capita income grew 3.5 percent annually, the highest level since the 1970s (ECLAC, 2011).

The Dragon, The Bear, and LAC

As China's growth slows, some analysts have become bearish on commodity prices. We may still be in the middle of what some economists call a 'supercycle.' These are situations in which growth accelerations push prices up, bucking the long-term trend of declining commodities prices. We could easily refer to the current period of higher commodity prices as a "China Cycle."

For years, many observers have called for China to rebalance its economy. Like Japan, South Korea, and other nations before it, China's expansion resulted from a developmental state harnessing market forces to integrate into world markets through export-led growth. The growth was unprecedented, enabling China to bring hundreds of millions of people out of poverty, but the model is showing signs of strain.

The crises in Europe and the United States caused a major drop in demand for Chinese exports. At the same time, China's investment as a share of GDP—brimming at more than 50 percent—far outstrips its 36 percent consumption rate. Historically at least, part of that gap stems from an undervalued exchange rate. Meanwhile, the environmental costs of rapid Chinese growth could be 9 percent of GDP or more (Xin, 2012).

China's 12th Five-Year Plan calls for more balanced growth and a lower annual GDP target of 7 percent. Some envision steady growth in the 7 percent range for the foreseeable future. Arthur Kroeber from research and advisory firm Dragonomics reminds us that China resembles developmental states like Japan and South Korea that "caught up" to the industrialized world. Lower-income countries can reach convergence with rich-country industrialization by simply using or copying existing technology. China has a ways to go before reaching the technological frontier (Kroeber, 2012; see also Rodrik, 2012).

Others see China's re-balancing—a combination of higher wages, appreciating exchange rates, and flexible interest rates—as a more painful process. Michael Pettis of the Carnegie Endowment for International Peace estimates that re-balancing will bottom out at 3 percent growth, but he calculates that household consumption may grow 5 to 6 percent per year (Pettis, 2012). Pettis notes that, by definition, rebalancing means a reduction in China's trade surplus.

Given that China is the destination for more than 10 percent of LAC exports, a Chinese slowdown will mean a decline in LAC exports, which, in turn, will slow the region's growth. A recent Bank of America study (BOFA, 2012) projects that if China's growth decreases to 8 percent in 2012 (from 9.2 percent in 2011), as projected by the International Monetary Fund, LAC exports will drop to 2.2 percent. Studies for the Inter-American Development Bank find that, historically, a 1 percent increase in LAC exports corresponds with a 0.5 percent increase in economic growth (Agosin, 2006). Using that estimate as a rule of thumb, a 2.2 percent decline in exports would result in a 1.1 percent decline in growth. A recent Fitch study (2012) estimates that a 1 percentage point slowdown in China's annual rate would cause a 1.2 percentage point drop in the LAC countries with the closest China ties (Argentina, Brazil, Columbia, Peru, Uruguay, and Venezuela). According to this formula, a drop to 7 percent GDP growth in China could lead to about a 4 percent decline in exports and a more than 2 percent loss of growth.

Bank of America characterizes these estimates as very conservative, projecting that a 1 percent drop in Chinese growth could lead to a 5 to 10 percent drop in prices, depending upon the commodity. In general, energy and food will likely remain robust, according to Bank of America, with declining demand and prices for metals.

There indeed is a fierce debate over the extent to which prices will continue to rise or, at least, remain high. Latin America's most prominent economist, Raul Prebisch, observed a long-term decline in LAC commodity prices and a subsequent decline in the terms of trade for LAC. After falling out of fashion, Prebisch's work has been reaffirmed, at least for non-oil commodities since the mid-19th century (Erten and Ocampo, 2012; Ocampo and Parra-Lancourt, 2010). Although the long-term trend for

non-oil commodities may be a decline in prices, history has shown that there are episodes of "supercycles," or surges in commodity prices that can last between 15 and 40 years.

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Most attribute the current "supercycle" to China's growth and its demand beginning in 2000; pundits' predictions range from a belief that the cycle is about to slow down to suggestions that it still has a long way to go. The Bank of America study, the *Economist*, and many analysts are more bearish (Sharma, 2012). Still others maintain that higher prices are the 'new normal.' HSBC Global Research estimates that prices may have peaked in 2011 but will plateau at levels higher than the 1980s and 1990s for years to come (HSBC, 2011). Speculative forces have skewed supply and demand in the wake of the financial crisis, making commodities markets much less predictable (UNCTAD, 2011).

If China sustains current levels of growth, demand for LAC's traditional export basket is likely to continue. But how much can China grow without significant reform, and what composition of trade will accompany continued growth and possible economic transformation? For LAC to prosper from Chinese imports of primary commodities, China must continue to industrialize. Mauricio Cardenas has shown that LAC commodity prices are tightly correlated to Chinese industrial production (Cardenas, 2010). A demand-led shift in China's development model could build out new cities and urban areas in the western part of the country, potentially boosting demand for iron ore, crude oil, and other commodities. Business as usual may benefit LAC in the short- and-medium terms, but it will be difficult to sustain the current model over time.

Predictions far into the future are beyond economic modeling. Anything could happen, including the discovery or invention of new products that could substitute for LAC exports; swings in speculation; environmental and climate-related limitations; and financial crises. With those caveats in mind, *if* China continues to grow (regardless of how fast) *and* it follows a consumption path like its Asian predecessors, interest in LAC's four core commodity exports to China should hold for a significant period. Previously, I compared annual income levels and per-capita consumption of crude oil, iron ore, copper, and soybeans with the consumption patterns in China, South Korea, and Japan—and the United States, in some cases (Gallagher, 2011). When it comes to crude oil consumption, China may not hit the East Asian plateau for another 46 years. If growth is one quarter of the historical rate, China will reach that level of oil consumption in 183 years. For iron ore, the stretch will be 50 years—and 70 years for copper. Soybeans present the most interesting case because China seems to have met the same level of soy consumption as in neighboring nations but at a much lower level of GDP per capita. If this is the case, Chinese demand for soybeans may not last so far into the future. However, unlike South Korea and Japan—which have no significant livestock industry that needs soy as a feedstock—China is developing this sector. Therefore a better comparison may be the United States, where the biggest demand for soy is in the feed sector. Comparisons of this sort offer uncertain predictions, however.

Economists dating back to Ragnar Nurkse (1959) remind us that as incomes grow, there is a greater share of income apportioned to the service sector. Technological change can raise efficiency in the natural resource sectors and substitutes for commodities are occasionally found. Increased demand also triggers increased investment and supply, both of which can push down demand and prices or, at the very least, slow their rate of increase.

Regardless of its composition, as the Chinese economy grows, it is plausible to predict that demand for at least crude oil, iron, copper, and perhaps even soybeans will hold for at least a few decades albeit at a slower pace as the "China Cycle," runs its course. Despite its recent slowing in economic growth, China is still poised to become the largest economy in the world around 2020. Even low levels of economic growth will translate into trillions in imports.

Responding to the China Challenge

There is more to consider in the China-LAC export commodity relationship than demand and price fluctuations. The gains from China trade have not fallen on all nations of the region. And those nations benefitting from China's economic engagement have not necessarily translated those gains into development. LAC has to hope that the "China Cycle" continues, and must take better advantage of this cycle. LAC will need to build institutions to steer the profits from commodity exports toward economic diversification and environmental protection.

Even if commodities prices remain high, they may not lead to prosperity for the region. Chinese trade and investment have been concentrated in six Latin American countries and a handful of sectors, chiefly in primary commodities. Research shows that development has remained elusive for commodity-dependent countries because they become subject to the resource curse. Demand tends to attract investment toward certain commodities at the expense of others. Such trade and investment can strengthen a nation's currency as well, making it even harder for firms outside of the extractive sector to export their products. Demand also attracts speculative investment in commodities, associated currencies, and public debt. Such investment is highly volatile and can make a nation prone to crises. It is also said that natural resources development spurs corruption, making it hard for governments to be disciplined enough to channel the profits of commodity exports into productive development.

The result can be de-industrialization, an erosion of non-commodity (and often employment-intensive) economic sectors, and costly environmental degradation. These trends eventually can lead to increased imports and decreased exports, creating balance-of-payments problems, and leading to poor economic performance. The solutions are well known but difficult to implement. In order to escape the resource curse, nations need to manage the resources properly, capture the windfall profits associated with their sale, and channel those profits into productive development for the short, medium, and long term (see Sinnott et al for a useful discussion of this issue in LAC, 2010).

During the China boom, there have been signs that LAC was de-industrializing along these lines. Few, if any, nations had policies in place to steer China-led growth so as to circumvent the resource curse. Trade and investment poured into Latin America's commodity sector during the China boom. As Latin American firms find it hard to compete in world markets, currency volatility is of grave concern, particularly in Brazil, Chile, and Colombia. During the China boom, approximately 90 percent of all LAC manufacturing exports lost competitiveness to China in world markets; that translates into about 39 percent of all LAC exports (see Gallagher and Porzecanski, 2010). By 2010, Brazil's commodities, as a percent of total exports, surpassed manufacturing for the first time in decades. Between 2009 and 2011, Brazil's currency appreciated by almost 40 percent, triggering cries for change from industrialists, workers, and politicians.

Mexico has been the hardest hit. Although modest success has been seen in places, overall results are disappointing. Mexican wage growth has been suppressed and plants have introduced new work processes. Despite the fact that Chinese wages have grown about 10 percent annually since 2009 and Chinese currency has been appreciating, 97 percent of Mexican exports continue to lose competitiveness with China. In 2000, China and Mexico each represented close to 5 percent of the world's computer exports. By 2011, 55 percent of all computers sold worldwide came from China, with just 5.8 percent coming from Mexico.

Few countries have attempted to channel the benefits of commodity-led growth into productive development. Chile gets high marks for stabilization funds that take windfall profits from copper exports to use in pension and social programs. The funds are linked to an overall fiscal program that allows Chile to engage in counter-cyclical macroeconomic policy—reducing spending and raising funds during boom times and increasing spending and raising fewer funds during slower periods. However, Chile invests relatively little of those funds into longer-run productive development. Brazil lacks a strong stabilization fund but has pumped some government revenue into a renewed national development bank that invests in diversified growth. Both Chile and Brazil have deployed innovative capital account regulations in an attempt to stem exchange-rate appreciation. But neither has been able to invest and regulate enough to diversify the nation away from commodity-led growth (Chile) or to stem de-industrialization (Brazil) and prevent costly environmental degradation.

Some LAC governments have expressed concern about their unbalanced trade with the China. In 2012, during a June visit to Latin America, Wen Jiabao proposed joint cooperation projects, including a $5 billion fund for manufacturing industry and environmental projects and a $10 billion credit line to boost infrastructure cooperation through the Chinese Development Bank. Citing food prices and food security, the Chinese premier offered $50 million to set up a special fund for agricultural cooperation and development and pledged to establish five to eight agricultural research and development centers, some agricultural processing demonstration parks, and several agricultural investment zones throughout LAC (Wen, 2012).

These initiatives show that the Chinese are willing to cooperate for mutual economic gain. Cooperation of this sort is in line with China's broader interests. However, now that China has made the first move, LAC will have to step up with matching funds for these projects. More importantly, it will also have to provide a vision for how to use the funds for diversification and sustainable development.

Latin America needs a sustained "China Cycle," but also must further capitalize on it. There are several starting points: expanding stabilization funds with commodity export revenue, developing an innovative approach to industrialization (both within and far beyond the primary commodity sectors) and human capital formation, and invigorating environmental protection. A business-as-usual approach could lead to macroeconomic, employment, and environmental problems over the longer term. China is already out-competing Latin America in world manufacturing markets. LAC nations must capitalize on the "China Cycle" before it is too late.

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