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China's "Second Wave" in South America

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There is no region in the world immune to the effects of China's ascension to global economic power. For South America, the macroeconomic and structural impact of China's rise was strongly felt during the first decade of the 21st century, and now the region is likely facing a "second wave" of Chinese investment.

How will this bilateral relationship evolve in coming years? China's economic and political interest in the region is increasing, as demonstrated by President Xi Jinping's visit to Brazil, Argentina, and Venezuela last year. However, the leading countries in South America are facing difficulties as a result of underperforming economic models adopted early in the 21st century and the deterioration of the political coalitions supporting them.

THE IMPACT OF CHINA'S RISE IN SOUTH AMERICA

The main channel through which China's ascent has impacted South America is bilateral trade. First, China became the primary or secondary trading partner with several countries in the region, notably Brazil, Chile, and Peru. Price increases for commodities exported from South America made trade even more attractive. This, in turn, generated a wealth effect that allowed many South American countries to implement social programs aimed at reducing poverty and inequality.

At the same time, a "North-South" pattern of bilateral trade was consolidated, with South American countries almost

exclusively exporting commodities and importing Chinese manufactured goods. The international specialization of South American countries in natural resource-intensive products became more accentuated. The competitiveness of manufacturing sectors in countries like Brazil deteriorated due to competition from Chinese goods and the appreciation of the exchange rate, a phenomenon associated with the improvement of the terms of trade that benefited the region's foreign trade during the first decade of the 21st century.

South American countries' policy responses to the rise of China were mixed. Brazil and Argentina tried unsuccessfully to protect their industries by implementing antidumping duties and increasing tariffs. For their part, Chile and Peru opted to negotiate free trade agreements with China and other Asian partners. Most recently, these two countries joined negotiations aimed at finalizing the Trans-Pacific Partnership trade agreement.

The year 2010 was the start of a new phase in economic relations between China and South America, as direct investment by Chinese companies in the region increased significantly in comparison to the previous decade. These investments mainly come from Chinese state-owned companies. They are aimed at capital-intensive sectors (energy and mining) and at countries like Brazil, Peru, and Venezuela. These large, state-run companies are the main drivers of China's policy of "going global" and its strategic goal of finding the natural resources necessary to secure food and energy security.



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China's large, state-run companies are the main drivers of its policy of "going global"

To ensure its investment in sectors with high political risk, the Chinese government has deepened its diplomatic relations with many countries in the region and used funds provided by Chinese public banks to lend to South American governments. Since 2005, these loans have reached over \$85 billion. They were primarily directed at four countries whose governments have economic priorities and foreign policy preferences that are distant from, or even opposed to, the interests of the United States. For instance, Venezuela—long a thorn in Washington's side—has received more than 50 percent of the total amount Beijing loaned to countries in the region, followed by Brazil, Ecuador, and Argentina. In many cases (such as Venezuela and Ecuador) Chinese loans are tied to the countries' exports of oil, an additional way for China to secure its loans.

President Xi Jinping's visit to Brazil, Argentina, and Venezuela (as well as Cuba) sends a clear message regarding China's priorities in the region. The visit also indicates that, for China, economic pragmatism includes a strong political component when it comes to choosing preferential trading partners in South America.

South American countries will experience a significant, although gradual, impact from the shift in China's economic model.

CHINA'S CHANGING ECONOMIC MODEL: IMPLICATIONS FOR THE REGION

What about the future of economic relations between China and South America? A central issue is the transformation of the economic model that has sustained China's growth to date.

The revision of China's traditional growth model based on investment and exports is the main focus of economic discussion in China and a point of interest for analysts and policymakers globally. This model has not only produced economic and trade conflict with China's partners, but it has also increasingly generated domestic unbalances related to income distribution, regional inequalities, and environmental impacts.

More recently, China's 12th Five-Year Plan, adopted in March 2011, and the third plenary meeting of the Central

Committee (CC) of the Communist Party of China in November 2013 represented important milestones in the reform of China's economic model. The 12th Plan set a goal of implementing a growth approach increasingly based on domestic consumption. However, it was not until the third plenary meeting of the CC that, for the first time, actual "incentives for Chinese families to convert income into consumption" were defined.¹ The reforms approved by the CC focus on the gap between income and consumption, offering "specific incentives for Chinese families to change their behavior."²

It is impossible to predict whether China's current reforms will allow for a smooth transition to a new growth model. The pace at which the reforms will take place is also unknown. Each time there is a slowdown in economic growth, voices in China ask for a new round of economic stimulus. For a ruling elite whose legitimacy is based on the capacity to deliver fast and uninterrupted economic growth ("performance-based legitimacy," as described by one analyst)³ the challenge of transition is daunting and more political than economic.

With regard to the direction and pace of reforms in China, the most plausible current hypothesis suggests a long and gradual transition lasting perhaps two decades.

The main consequence of this slow transition for countries in South America is that the change of China's growth model will not produce anything close to an "external shock effect" on their economies, since the impact will be diluted over time.

As a consequence, macroeconomic effects (on commodity prices, terms of trade, and exchange rate appreciation) and structural impacts (on the performance of the various sectors of the economy) generated by China's transition to a new growth model will tend to be less intense and less concentrated in time for South America than those observed during the first decade of the century. Despite this, the change in China's economic model will not provide significant room for a change in the pattern of the trade relationship (South America exporting commodities and

importing Chinese manufactured goods) consolidated over the last few years.

That said, there is no doubt that South American countries will experience a significant, although gradual, impact from the shift in China's economic model. The slowdown in China's economic growth that will accompany this transition, a lesser role of investment in domestic demand, and higher family incomes could generate different effects on Chinese imports from South America.

In principle, countries exporting agricultural products and livestock would suffer a lesser impact than those countries exporting, for instance, minerals. This holds true when taking a short-term view, but the hypothesis has to be nuanced when one looks farther and takes into account the perspectives of China's massive and accelerated urbanization, in itself a part of the changing economic model. The rapid growth of the urban population could help sustain, in the mid-term, the demand for minerals (especially the iron/aluminum complex).⁴

However, the greatest impacts of China's new growth model on relations between China and South America are expected to be found in the amount of Chinese investment and financing targeting the region. In a Chinese transitional scenario, investment flows will increase toward new business opportunities. These flows will primarily involve state-run companies concentrated in natural resources and capital-intensive sectors, reinforcing a trend that has been evident since 2010.

Therefore, Chinese investment in South America would initially increase. But this process would mainly involve the same state-run companies that have already been investing in the region in energy, mining, etc. Some diversification of Chinese investment could be expected, though probably only in Brazil, whose large domestic market is already attracting Chinese companies in the consumer goods sector.

With these caveats, the dominant trend is one where Chinese investments will be targeted at natural resource-intensive sectors and will generate new commodity exports to China. In this sense, this wave of investments will contribute little or nothing

to the diversification of South America's export basket.

These investments will be associated with Chinese public financing distributed in the region according to a combination of economic interests and political convergence. There is little to suggest that these criteria will change in coming years. Again, it is worth recalling the itinerary of President Xi Jinping in his visit to the region.

CHINA'S "SECOND WAVE" AND SOUTH AMERICA'S FRAGILITIES

In fact, a clear trend that emerges from China's recent diplomatic engagement in South America is the overlap between political and economic issues in Beijing's regional agenda.

If this analysis is correct, a key variable for analyzing the implications of a second stage in China-South America relations is the present political and economic environment (and the one foreseeable for the next few years) in South American countries.

There are striking differences between South America's political and economic climate today and the one prevailing 10 to 15 years ago, when China first began to intensify its trade relationship with the region. At the time, South America enjoyed a favorable macroeconomic situation, public spending was controlled, and the fiscal environment made enough room for adopting ambitious social policies. The trade relationship with China facilitated growth based on increased domestic consumption while keeping inflation under control and generating fiscal resources that funded social reforms.

The situation today, as South America faces a "second wave" in its relationship with China, is quite different. In fact, some of the largest economies in the region are facing serious economic difficulties (such as reduced growth and fiscal and external accounts unbalances) in various degrees. In addition to economic difficulties, political tensions are growing within coalitions that have been in power since the early 21st century, as can be seen in Venezuela, Argentina, and even Brazil.

The expected economic effects of a second wave of Chinese investment are mixed from South America's point of view.

These factors are eroding the ability of South American countries to attract resources to bridge their external gaps. By the same token, they limit the “fiscal space” for industrial and social policies in the region.

Within this fragile context, what can be expected of a second wave of Chinese investment? The expected economic effects are mixed from South America’s point of view. As noted, this second wave will not produce the macroeconomic impact that allowed the region’s countries to pursue developmental and social policies in previous years. At the same time, China’s contribution to South America’s “deindustrialization” will be lesser than seen in the first decade of the century.

China’s increased investments in the region—and the financing opportunities offered by its public banks—could help countries like Brazil expand exports of commodities and improve the logistical infrastructure that is key for the export competitiveness of these products. In economic terms, this represents a limited but not marginal contribution. As an important side effect of these trade-related investments, we will likely see the region being increasingly pushed towards specialization in commodities and the perpetuation of the current bilateral trade pattern between South America and China. This may not be an exciting scenario, but it is the likeliest course of future economic relations between China and South America.

In the political sphere, the implications of President Xi Jinping’s visit are not as clear. However, the visit does create some concern in a region where, unlike China, socialism is still perceived as an alternative economic model. In this context, a new wave of Chinese investments and loans could give an additional breadth to populist and nationalist policies that are becoming increasingly costly in economic as well as political terms.

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ENDNOTES

1. Stephen Roach, “To Bring Life to the Chinese Consumer,” *O Estado de São Paulo*, December 1, 2013, page A23.

2. The third plenary meeting of the CC announced the easing of the “one-child policy.” This policy has played an important role as a component of the previous growth strategy by acting as a disincentive to household consumption and an incentive to savings (and investment).

3. Guy De Jonquières, *The Problematic Politics of China’s Economic Reform Plans*, ECIPE Policy Brief no. 5/2014 (Brussels: The European Centre for International Political Economy, 2014).

4. Mauricio Mesquita Moreira, “China’s New Development Model: Impacts on Africa and Latin America” (PowerPoint presentation at the Red Mercosur-IDB-UBA conference, March 25–26, 2014, Facultad de Ciencias Económicas, Universidad de Buenos Aires).

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