The South African Institute of International Affairs'
China Working Group

30 March 2006

"In search of a demandeur – Exploring the contours of a SACU-China trade deal"

Record of discussion

1. Background

China's size, rapid economic growth, and even more rapid integration into the global economy make it a driver of significant change worldwide. If even the most conservative predictions are accurate, China will be a globally significant economic power within 50 years. In some respects, China already is. Hence for most countries, South Africa included, China has become a major foreign policy priority. The desire to build a sustainable, mutually beneficial relationship is strong.

Trade agreements of various forms are increasingly becoming the keystones for achieving such goals. Both the Southern African Customs Union (SACU) and China are active on this front, and last year expressed an interest in pursuing a deal with each other. On some levels the economic and political rationale for doing so is clear-cut, but, equally obviously, there are complexities that require deeper exploration.

2. Proceedings

Welcome—Peter Draper, SAIIA Research Fellow

Chair—Dr. Razeen Sally, London School of Economics

Dr. Sally opened proceedings by highlighting what the paper covers: China's rise and integration into the global economy, the impacts thereof, and how these affect the likely contours of a China-SACU FTA.

Presentation—Phil Alves, SAIIA trade economist

Note: The presentation covers only parts of the paper, meaning that some questions and comments do not relate directly to the recorded discussion given below.

Introduction

- The paper is about China's emergence, its growing impact on the world economy, and how all this relates to the developing China—SACU relationship. The point is to provide the proper backdrop or context to any potential bilateral trade negotiations.

- Charlene Barshefsky: "China's WTO accession will open the world's largest nation to our goods, farm products and services in a way that we have not seen in the modern era."
- China is now the second largest recipient for FDI annually, and possesses the world's third largest FDI stock
- China is becoming an increasingly important price setter in world trade, for both its imports *and* exports. China's terms of trade have been steadily worsening.
- Refining or even re-defining the international division of labour.
- Altering the nature and quickening the pace of global and, especially, East Asian economic integration.
- China's phenomenal trade performance is the most obvious feature of its emergence
    - China's export growth = 15.2% annually between 1995 and 2004; South Africa's = 5.3%; the world average = 6.0%.
    - China accounted for 20% of global trade expansion between 2000 and 2003
    - But China's *net* export growth only started increasing in the mid 1990's.
    - China now regularly records massive trade surpluses, mainly in trade with North America, Europe and Japan.
    - China has deficits with all other regions, but obviously this picture varies across countries within these regions. South Africa, for example, is running a large deficit with China, second only to that with Germany. Other resource rich developing countries, such as Brazil, Chile, Malaysia, etc., are showing healthy surpluses.

China's growth

- GDP grew 9.7% annually, between 1983 and 2003. This is based on OECD statistics, which exclude the 2004 revisions to China's GDP. The World Bank estimates that China's annual growth rate between 1993 and 2004 should be revised upwards by about half a percentage point.
- Between 200 and 300 million Chinese have been pulled out of poverty since the early 1980s.
- The strategy has been "savings and exports". China's combined public and private savings averages about 40% of GDP, to which one must add large (but disputed) FDI inflows, which has led to high rates of capital accumulation.

- Is factor accumulation the main driver of China's growth? Analyses and opinions differ, with some giving more weight to productivity gains (e.g. Paul Krugman, 1994; IMF, 1997).
- Looking forward: is the current growth pattern (and therefore rate) sustainable? Capital allocation in China is and has for some time been highly inefficient, resulting in excessive investment in manufacturing capacity and supporting infrastructure. Add this to extremely high investment/GDP ratios (historically and compared to other Asian economies at similar levels of development), and one must ask how long investment-led growth can last. The problem is commonly cast as "investment overheating".
- Another major concern, amongst many others, is a perceived over-reliance on exports. The key question here is whether or not China's growth is export-led. Can a significant slowing of export growth, in the absence of a concurrent rise in domestic consumption, have no serious effect on GDP growth?
    - The Asian Crisis would suggest that GDP growth is not closely linked to export performance—the former slowed only slightly while the latter collapsed (as did FDI inflows).
    - Other research shows that changes in net export growth show no systematic relationship with changes in GDP growth.
- Nevertheless, so much of the FDI and productivity gains witnessed in China happen in the export processing zones, which are over 60% foreign owned, and much more efficient that most of the rest of the economy, which is dominated by inefficient SOEs. Also, the external sector is now very large relative to GDP (imports + exports totalled more than 65% of GDP in 2003 according to the World Bank). It is thus hard to see how China would simply shrug off a significant drop in export performance without a similarly significant rise in domestic consumption.
- Which raises the next obvious question—can China's recent 30% annual export growth rate be sustained? Simple arithmetic suggests not (at these rates exports double every 3 years). So the domestic consumption challenge is real and urgent.

China's impact on world and E. Asian trade

- Impacts are not universal across the regions and sectors, but have been most acutely felt in China's neighbourhood. What lessons might there be for SACU?
- 3 components of the relationship between non-China East Asia and China:
    - China's demand for resources—South East Asian neighbours have benefited along with most resources exporters. This is good news for SACU, although it is clear SACU needs to raise its primary

export growth rate. The opportunity China presents is currently under-exploited by SACU countries.
    - High technology trade—involving mainly (Asian) MNCs. Components get shipped to China for processing and then off to the West and Japan, creating a complementary system. Unfortunately no or very limited lessons and benefits for SACU here. These countries simply aren't plugged into the relevant MNC networks in any meaningful way.
    - Significant displacement in light industry, driven in the main by China's labour cost advantages, amongst many others—SACU countries are not alone in feeling the severe effects of China's global integration in sectors such as apparel and footwear. Especially since the expiration of the ATC.

- However, China is a globally significant importer, particularly of developing country exports. It is having a net positive effect on the trade balances of many developing countries, including many in Africa. Why is this not the case with South Africa? And would an FTA help to change that?

- Perhaps more concerning is the emerging *pattern* of trade between SACU and China
    - SA exports to China are booming, growing at about 40% annually in recent years. But most of the growth and projected market share gains are in resource-based products (metals and chemicals in particular). Other (lesser) gainers include machinery, some textile products, plastics, and some forms of transport equipment.
    - China's biggest exports to SACU and strongest potential gains are in textiles and apparel, footwear, and electrical machinery.
- So, with exception of some machinery exports from South Africa, the China and SACU are largely complementary sets of economies. This implies huge opportunities for both sides and significant gains from trade from both.
- However, SACU has well documented unemployment problems, which are compounded by job-losses in sectors where China is very competitive, i.e., labour intensive light industries. So, if light industry is the largest source of unskilled jobs in SACU, more trade with China will not offer the kinds of developmental benefits SACU needs
- But one has to ask two questions:
    - Would less clothing imports from China help? Perhaps, but probably not much. There are other, more fundamental reasons why some parts of SACU's light industry sector are suffering. These include high relative unit labour costs, a strong exchange rate, small scale, outdated technology, high freight costs, and so on.

    - And this must be balanced with the other crucial question: surely there are large welfare gains on offer from cheaper imports? After all, there are many more poor people *outside* the clothing and footwear industries than in. Furthermore, service sectors such as wholesale and retail have expanded rapidly in light of cheaper products and higher sales volumes. These businesses create many low-skilled jobs, particularly in the informal sector.
- But overall, the point to take away is that trade between China and SACU is ostensibly inimical to job creation and poverty reduction in the latter (even if that is not clearly the case). This has ensured that the "China trade question" is now an intensely politicised issue, made so particularly by trade union movements but tacitly supported by business too, meaning that a full FTA will almost surely not find support in SACU countries.

What kind of deal then, if any?

- The backdrop to potential negotiations is complex and politically charged, at least in most SACU countries, if not China.
- Need to add to this an analysis of the trade strategies of both SA and China. Is either side likely to push hard for a comprehensive deal?
- SA signed on to the Marrakech Agreement in December 1994, taking on fairly onerous liberalisation commitments, and has exceeded them—by some margin in some sectors—since then. Also negotiated the TDCA with the EU, the Trade Protocol with SADC, and there is a potential FTA with the US, but this process seems to have stalled. This covers most of SA's "priority partners".
- Then there is Mercosur, with which a preferential agreement is about to be completed. The approach has been cautious and the deal is very narrow. It involves 1 000 products or less out of a possible 8000-10000. Tariffs have not come down to zero—the preferential swaps are not large. Its impact is likely to be minimal. Possible reasons for this are: Southern partners are new to South African business; there is a distinct lack of complementarity; there are significant benefits to a political relationship, which could be undermined by economic realities. Hence the gradual approach, but it remains to be seen if this gradualism will yield a more commercially meaningful agreement in the future.
- A similar deal is expected to be realised with India.
- Which implies that SACU will seek something similar with China, especially considering the difficult political challenges. Whether or not this is wise is assessed in the conclusion.
- How might China react to such an approach?
- China is extremely active on the FTA front, especially in East Asia. Although Japan is still the regional leader, it has traditionally rested formal regionalisation processes. China is filling that gap. But there is no

uniformity in China's approach. Its flexibility and pragmatism, particularly with partners outside East Asia, is self-evident. China's most comprehensive deals are with Macao SAR and Hong Kong SAR, for obvious reasons. China has made serious commitments in the ASEAN+ processes, but these are complex and slow moving, and not likely to cover more than goods trade. Nevertheless, China is the principal *demandeur* in the ASEAN process.

- It is not clear that China is similarly driving the processes with New Zealand and Australia. Both embarked on lengthy research and consultation processes before engaging China in trade negotiations. These are currently underway. It is highly unlikely that either Australia or New Zealand will settle for anything short of a comprehensive deal, including services and disciplines on investment.
- The deal with Chile was restricted to goods and by all accounts went off smoothly and quickly. Chinese flexibility is evident, as there are long phase-ins, and some significant carve-outs for Chilean light industries (including some clothing and textile products.
- Given this, SACU's likely reluctance will likely not come under pressure, leading to an agreement high on political symbolism and little else. At least in the short- to medium-term.

Conclusions

- Big question—is the likely scenario outlined above desirable for SACU? The reality is that China is here to stay. All trading nations need to actively seek ways to adapt, SACU included. What is the best way to do that? To shy away, protect sensitive sectors, and effectively mute or remove the incentives required for adjustment to a more sustainable growth platform in SACU? Or to use trade with China to accelerate the necessary process of adjustment towards a more flexible economy that is focussed on core competencies. This is not to argue in favour of reckless opening. But engagement with China must be across a comprehensive set of trade issues, and must cover as much goods trade as possible. Any flexibility on offer from China should be in the form of longer implementation periods, not wholesale carve-outs. This would provide the certainty required by struggling industries to implement more comprehensive adjustment plans. And it should also be made clear that trade China does not imply a total hollowing out of SACU's clothing industries, for example. To be sure, in their current form in SACU, these industries are not efficient or competitive. But there are already signs of healthy adaptation, implying that the nature and size of these industries will respond to Chinese pressure in ways that improve productivity and the sustainability of their long-term outlooks. This is ultimately the position in which all SACU producers need to be.

- Have to also weigh the real bureaucratic and business admin costs of another trade agreement with another set of rules of origin (amongst others) against the potentially limited market access gains of a narrow deal.
- And, not to belabour the point, but imports from China are good for the majority of poor SACU citizens.
- But the macro-picture (current account deficit) certainly is worthy of concern. Decisions vis-à-vis a trade agreement with China ought to consider two possibilities in this regard. In as far as trade with China channels more resources into SACU's more efficient sectors, the long-term effect on current accounts should be positive (add to this SACU's currently under-exploited primary product exports). However, the short term could see a rapid increase in trade with China precipitating a balance of payments crisis. This is another reason to manage to process of opening carefully, but is not a good reason to refuse to open up in meaningful ways.

3. <u>Comments and questions (only most salient included, especially in light of subsequent revisions to the paper)</u>

Ms. Tanya von Meelis (Congress of South African Trade Unions—COSATU)

- Would less trade erase SACU's problems? In the short-term certainly.
- Need to ask what is the opportunity cost of trading with China? The more we export our resources, the less we have to put into the promotion of light industries.
- Also need to understand that currently we are not talking of a proper FTA with China—just a trade agreement. But COSATU would argue that even this is possibly not the best option
- Also, it would be useful to locate China in the political economy. For example, to consider what is happening in the WTO, how China engages within the WTO framework.
- Last, the paper implies that China is the single most important driver structural change in SACU. Is that accurate? What about the US FTA? And trade with Southern partners?

Mr. Zhou Yuxiao (Minister Councillor—Chinese Embassy in South Africa)

- Must recall that SA moved first—SA approached China. At the first Bi-National Commission (BNC) meeting, SA put the idea formally on the table and the Chinese were and remain very open to it. Discussions were healthy until the textile and clothing issues became problematic, which is why China has agreed to some form of voluntary restraints on trade with South Africa [ed: no-one yet knows the details of this deal]. SA negotiators say they have to report to parliament; China is waiting.

- Concerns of COSATU are warranted. Textiles and clothing may be affected. But China is looking for a win-win situation in order to foster a stable and sustainable commercial relationship.
- Globalisation calls for competitiveness—this should be even COSATU's starting point. Many constituents in China reacted negatively to joining the WTO. Politicians argued that China would be wiped out, citing massive investment and "takeover" by Western firms. But now China is building its own brands. Detractors called for continued sheltering, but Chinese business has instead learnt to take advantage of the increased competition.
- China is also looking for to promote domestic consumption. It is not in China's interest to depend more and more on exports. Also, it is not in China's interest to depend more on imports, particularly energy imports. Diversification into gas, solar, hydro, as well as improving the efficiency of coal usage is therefore central to China's future.
- The mood in SACU is reminiscent of that in East Asia 20 years ago. Today, these countries welcome and rely on their relationship with China. In short, they were worried, and are still worried in some cases, but by and large have adjusted to China's emergence and now benefit tremendously from trade with China.
- But in sum, Chinese foreign policy will have failed if Africa is not convinced of possible gains from dealings with China

Mr. Peter Draper (SAIIA Research Fellow)

- Picking up on the Minister Councillor's final points: the state of the debate in South Africa is largely missing the point. Whether or not engaging China is a good idea is no longer debated in Australia, New Zealand, and others. Economic logic is bypassing potential political problems. But so far we here in SACU have not figured out how to handle the sensitivities. Is it so bad to export commodities and services and only a limited range of manufactures? Australia, New Zealand, and Chile all do exactly that.
- More broadly, the Asgi-SA document (SA's new plan for achieving higher GDP growth rates) says little about the SA's engagement with the global economy. It highlights only problems with a strong but volatile currency and some trade negotiations (the WTO). Liberalisation and globalisation are falling off the agenda in SA, which seems again to be trying to build a fortress based on protectionist logic. This is not sustainable.

Ms. Tanya von Meelis (Congress of South African Trade Unions—COSATU)

- Commodity dependence is unwelcome for a number of reasons, the main one being declining terms of trade over time (the current China-driven

boom notwithstanding). There are also problems around a stronger exchange rate.
- A challenge to SAIIA—What are the options vis-à-vis China? Is an FTA the only one? How do we find ensure mutually beneficial relationship that contributes to job creation and poverty alleviation? What about looking at technology and education transfer agreements, for example?

Dr. Razeen Sally (Senior lecturer, LSE)

- Paper is too pessimistic about China's growth prospects, both in GDP and exports. International demand is arguably sufficient to absorb a continued expansion of exports. On GDP, there remains an awful lot of catching up to do. Don't expect a slow down anytime soon.
- South Africa bears a strong resemblance with Australia and some Latin American countries. So it will gain from a comprehensive agreement with China, as these countries are expected to do.

4. Synopsis

Much of the debate revolved around South Africa's economic growth path and how this needs to adapt to a rising China. Opinions diverged over whether exporting more resources was good for economic development or not, although there was a consensus that the proceeds need to be ploughed back into building supply-side capacities, but also social development. A further fault-line was the issue of protecting SACU from Chinese imports, with opinion sharply split between those who see it as futile and hence favour quick adaptation, and those who wish to retain and possibly increase protection to alleviate social dislocation. There was a degree of consensus that for now a preferential trade agreement is the preferred option, although some were of the opinion that a comprehensive FTA would both facilitate the necessary adjustments and open better market access for SACU exports into the Chinese market.