Trade Strengthens Ties between China and Latin America

Mutual economic interests have caused the trade relationship between China and Latin American countries to blossom in recent years, and the benefits to the participants have been manifold. But how will trade and currency policies—already a source of friction—affect the delicate balance of interests down the road?

As China's economy has grown, so has its economic influence in Latin America. Chinese imports from Latin America, mostly commodities, have surged and exercised a profound impact on the economies of the exporting countries in the region, while Latin American imports of Chinese products have had a dramatic effect on both consumers and producers. China is now Brazil's top trading partner, Chile's second-largest export market, and Peru's second-largest trading partner. All three of these countries have experienced high levels of economic growth in recent years. Conversely, countries that are not big exporters of commodities to China, such as Mexico and the Central American countries, have not enjoyed the same levels of growth.

China's economic growth has averaged a dizzying 10.3 percent real annual growth since 2000, and it's now the second-largest economy in the world in terms of gross domestic product (GDP) at official exchange rates. In 2000, Chinese trade with Latin America amounted to just over $12 billion. By 2009 it had grown to around $118 billion. The Economist Intelligence Unit projects that during the next five years, China's real GDP growth will be between 8 percent and 9 percent, making continuing Chinese demand a key component of global growth and an important market for Latin American exports. The United Nation's Economic Commission on Latin America and the Caribbean (ECLAC) forecasts that by 2015 China will surpass the European


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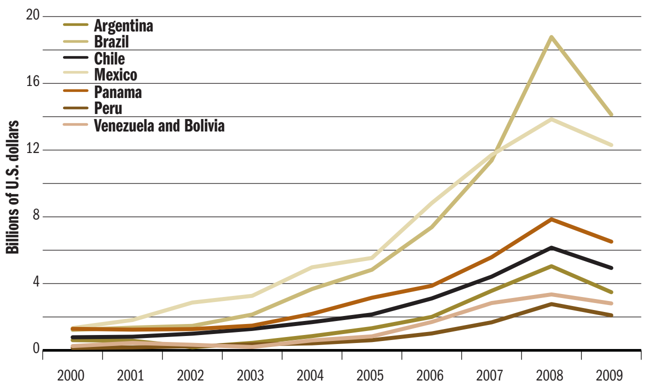
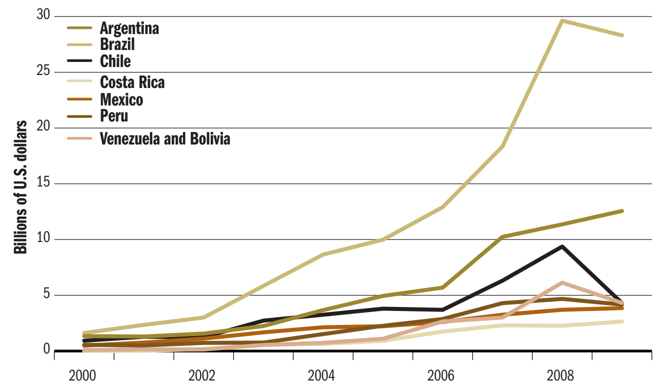
Chart 1
Latin American Exports to China



Source: International Monetary Fund, Direction of Trade Statistics

Chart 2
China's Imports from Latin America



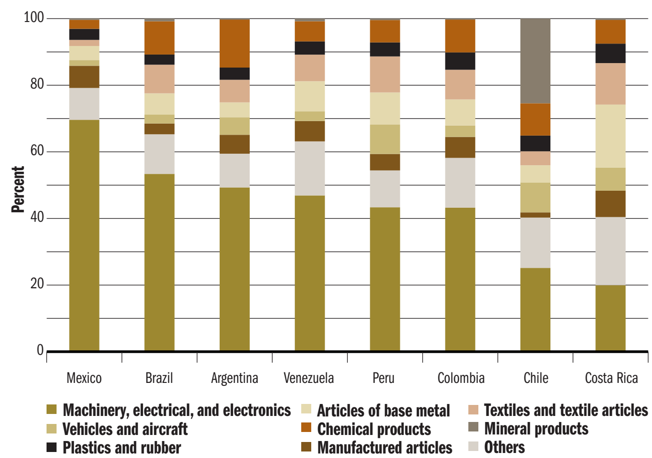
Source: International Monetary Fund, Direction of Trade Statistics

Union to become Latin America's second-largest export market after the United States and that by 2020 China will purchase nearly 20 percent of the region's total exports.

Chinese demand for Latin American exports played a vital role during the global financial crisis and recession. Unlike previous downturns, Latin America's economies were strong when the recession hit, with solid domestic macroeconomic fundamentals (such as low fiscal and current account deficits and a greater degree of exchange rate flexibility), low levels of short-term foreign debt, and high levels of international reserves. Chinese demand for commodities meant that exporting economies enjoyed growing volumes and high prices for their products. Not coincidentally, the Latin American countries with the highest levels of exports to China, including Brazil, Chile, Peru, and Argentina (see chart 1), were the countries that recovered fastest from the recession.

In recent years, imports from China have also risen dramatically in the region, particularly for Brazil, Mexico, Chile, Venezuela, and Argentina, a rapid rate of increase slowed only by the economic crisis in 2009 (see chart 2). These imports from China are concentrated in processed and manufactured goods (see chart 3). China is also investing in energy and mining projects throughout the region.

Chart 3
Latin American Imports From China



Note: Data are for 2010.
Source: Inter-American Development Bank

The progress of processed goods

When it comes to trade between China and Latin America, the region has a clear comparative advantage with respect to primary products (raw materials and resources used in the manufacturing process), but other factors also affect the composition of trade. China imposes barriers to trade, including relatively high tariffs and directives from state-owned firms that prioritize the purchase of domestic goods. The restrictions on trade also tend to increase with the degree of processing and value added of the traded good. For example, Argentina found itself in a trade dispute with China when it tried to export soya oil instead of raw soybeans to China. When its shipments were deemed unacceptable because of alleged sanitary concerns, Argentina relented and went back to shipping soybeans. Finally, China's foreign exchange policies, which hold down the value of the Chinese yuan, serve to increase the price of the Latin America's exports to China. Taken together, these restrictions complicate efforts to expand exports of more processed and manufactured goods.

An export boom based on only a few primary products is not without risks, however. A significant slowdown in China would have a significant impact on growth in Latin America, as trade and investment flows would diminish. Furthermore, beyond the fact that an export boom based on only a few primary products leaves that country vulnerable to price volatility, countries undergoing a natural resource boom are vulnerable to the so-called resource curse, also known as Dutch disease, which has the effect of diverting investment from other economic activities. (For a detailed description of the resource curse, see "Brazil's Oil Discoveries Bring New Challenges" in the first-quarter 2011 issue of *EconSouth*.) In short, Latin American countries face their share of challenges when it comes to diversifying the narrow range of goods they currently export to China.

Whereas Latin America exports mainly primary products to China, its imports from China are primarily processed goods, which have more value added and require more inputs of labor and capital. Most imports from China are in machinery and electrical and manufactured goods (see chart 3). This trade asymmetry is a concern in Latin America as primary products are finite, their value added is limited, and their potential impact on long-term development could also be limited if the revenues from these resources are not allocated wisely.

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Latin America-China trade: A tale of two regions?

As a recent report by the Inter-American Development Bank (IADB) emphasizes, emerging markets are leaders in global growth and now account for 75 percent of world demand growth, up from 50 percent in previous years. Those countries whose trade is concentrated where growth is strongest—primarily emerging Asia—are reaping the benefits of higher prices for their commodities and stronger capital inflows. The IADB calls these countries the "Brazilian cluster," which also includes such countries as Argentina, Chile, and Peru. Paulo Sotero, the director of the Woodrow Wilson Center's Brazil Institute summarized this relationship bluntly when he said in a news report, "Brazil probably would not be an emerging market and emerging country today without its trade relationship with China. You cannot understand Brazil's economic growth without trade with China."

In contrast to the Brazil cluster, the IADB report groups the countries of Central America and the Caribbean with Mexico in the "Mexican cluster." These are countries with greater trade exposure with the United States and other industrialized countries and more generally tend to be commodity importers (Mexico's petroleum exports being an exception). Their dependence on slower-growing regions for trade, tourism, investment, and remittances has contributed to a slower recovery from the global recession. Furthermore, the IADB argues that these two clusters of countries are on different growth trajectories, as it sums up in the report's title: *One Region, Two Speeds?*

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The factors that contribute to these "two speeds" are described in great detail in Kevin P. Gallagher and Roberto Porzecanski's 2010 book, *The Dragon in the Room: China and the Future of Latin American Industrialization*, which describes how Latin American exports to China are concentrated in a few countries and in a small cluster of commodities. The authors note that the top 10 commodity exports from Latin America to China represent 91 percent of all commodity exports and 74 percent of total exports to China. The top five commodities represent 75 percent of commodity exports to China and 60 percent of total exports from Latin America to China. Of these top five commodities (see chart 4), four countries dominate the list: Argentina, Brazil, Chile, and Peru. Thus, when describing the region's commodities boom, there is a group of countries that are "winners."

For a country like Mexico, which is not a major commodity exporter to China but does compete directly with China for manufactured exports, the picture is far less rosy. Gallagher and Porzecanski looked at the degree to which China is a competitive

The Brazil-China Relationship

Bilateral trade between Brazil and China soared between 2000 and 2010, going from $2 billion to $56.2 billion in that period. Besides surpassing the United States as Brazil's largest trading partner, China also became Brazil's largest single foreign direct investor in 2010, at $17 billion, up from the 29th largest just one year earlier. While Chinese demand has been a key factor in Brazil's economic resurgence, the Brazil-China relationship also has had its share of friction.

Soaring imports from China, which grew 61 percent in 2010 from 2009 levels and 47 percent in the first two months of 2011 year over year, have caused considerable alarm among Brazilian manufacturers and led to growing tensions between the two countries. Of Brazil's exports to China, 84 percent were raw materials in 2010, with iron ore, soy, and crude oil accounting for three-quarters of exports. Meanwhile, 98 percent of imports from China were manufactured goods, led by televisions, LCD screens, and telephones. Chinese foreign exchange policies, which serve to undervalue its currency, combined with the strength of the Brazilian real, have exacerbated pressures on Brazilian manufacturers. The severe impact on Brazil's textile and shoe industries has led the National Industry Confederation to warn about deindustrialization in those sectors. Some manufacturers have succeeded in their pleas for government protection: in December 2010, Brazil increased import tariffs on a list of toys from 20 percent to 35 percent. Brazil has also initiated a number of anti-dumping investigations against Chinese products.

Since the current relationship between Brazil and China is one in which Brazil exports raw materials and imports manufactured goods, Brazil is seeking greater balance. The country seeks to sell more value-added and processed goods to China, and it wants Chinese investment to go beyond natural resource extraction. Ninety percent of foreign direct investment is in natural resources.

On her trip to China in April 2011, Brazilian President Dilma Rousseff signed 22 cooperative agreements that included joint development on agricultural technology and biofuels and research and development in nanotechnology, electricity, and oil. For example, Petrobras, the Brazilian government–owned energy company, has agreed to work with the Chinese companies Sinochem and Sinopec on deepwater prospecting technologies. (See "Brazil's Oil Discoveries Bring New Challenges" in the first quarter 2011 issue of *EconSouth*.) The Brazilian mining company Vale received a $1.23 billion loan from the Chinese Export-Import Bank to build 19 very large cargo ships (dubbed "sea monsters") to transport iron ore. China also agreed to $1.2 billion worth of additional purchases of Brazilian Embraer planes, and Taiwan-based Foxconn was said to be considering a $12 billion, five-year investment in Brazil. Nevertheless, despite these agreements, given Chinese demand for Brazil's raw materials and Brazil's need for investment (not to mention the lure of lower-priced manufactured imports from China), the basic patterns of the China-Brazil trade relationship are unlikely to change any time soon. ∎

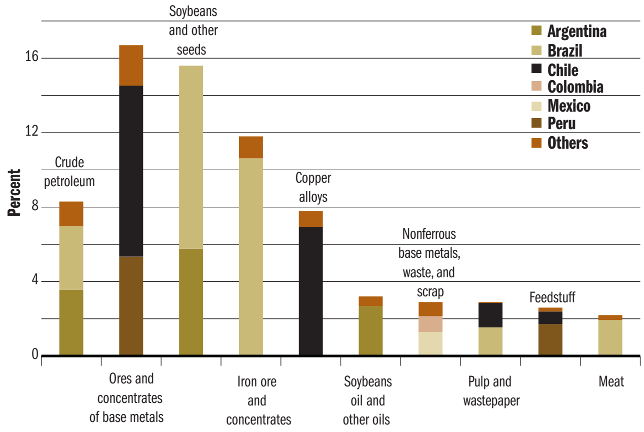
threat to Latin American exports. They labeled China as a direct threat in a given sector if its exports of manufactured goods rose while a given Latin American country's exports shrank, and a partial threat if both countries' exports rose but China's rose at a higher rate. Using 2007 data, the authors found that China was a direct threat to 70 percent of Mexico's manufactured exports and a partial threat to 28 percent of its manufactured exports. In other words, 98 percent of Mexico's manufactured exports (which make up 73 percent of Mexico's total exports) faced a competitive threat from China.

In contrast, China's competitive threat with respect to Brazil is smaller (see the sidebar). Only 39 percent of total Brazilian exports are manufactured goods, and of those, only 9 percent faced a direct threat from China, with 30 percent facing a partial threat. Overall, for Latin America and the Caribbean, Chinese competition is a direct or partial threat to 93 percent of manufactured exports. When the manufactured goods are lumped together with commodities, Chinese competition is a threat to 41 percent of total exports.

A complex relationship develops

Demand for commodities is keeping prices high, bringing benefits to Latin America that are concentrated among six countries. On the other hand, Latin American manufacturers are struggling against very tough competition with respect to exports. While Mexico is the most broadly affected, the rapid rise of imported manufactured products from China has created tension throughout the region.

Chart 4
Latin American Commodity Exports to China



Source: *The Dragon in the Room: China and The Future of Latin American Industrialization* by Kevin P. Gallagher and Roberto Porzecanski (Stanford University Press, 2010)

Clearly, the relationship between China and Latin America is a complex one. Some countries—such as Brazil, Chile, Peru, and Argentina—have seen export earnings soar with trade contributing to high levels of GDP growth. Other countries—such as Mexico and the Central American countries—have not reaped such benefits from trade with China. In fact, countries competing with China in the manufactured exports arena face significant challenges. Brazil's government has made a significant effort to reduce trade imbalances, but it is clear that many of the asymmetries are deeply embedded in the existing trade relationships. The broad contours of the China-Latin America economic relationship are likely to persist in the years ahead. ▮

This article was written by Stephen J. Kay, coordinator of the Atlanta Fed's Americas Center, and Gustavo Canavire-Bacarreza, a research intern at the Atlanta Fed and a PhD candidate in economics at Georgia State University.

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they buy and prices fall when they sell. Indeed, Pirrong finds that we do see a bit of this correlation, but based on his analysis the impact of speculative trading raised oil prices by 2.56 percent during 2006–8, a tiny fraction of the actual 123 percent increase. Moreover he finds that speculators were at times selling while prices were rising, contributing to a smaller price increase overall. Finally, his analysis underlies the earlier comment on inventories: inventories of oil fell during the price rise in 2008 and expanded as the price fell, inconsistent with speculative hoarding.

On January 26, 2011, in accordance with the Dodd-Frank Act, the CFTC proposed new rules to limit excessive speculative trading positions in a variety of commodities including oil. Since then, the commission has received nearly 12,000 comments and has not yet issued a final rule. Complicating its task are myriad institutional details that I've not discussed here, including the trading activity that occurs outside of exchanges and the difficulty of distinguishing some speculative activity from hedging-related trading (most often involving financial firms that use futures to hedge other financial transactions).

As I've discussed here, there is currently no clear economic basis and no empirical smoking gun to indicate harmful effects of speculation in the oil market. Perhaps CTFC Commissioner Michael Dunn said it best in January: "To date, CFTC staff has been unable to find any reliable economic analysis to support either the contention that excessive speculation is affecting the markets we regulate or that position limits will prevent excessive speculation. The task then is for the CFTC staff to determine whether position limits are appropriate. With such a lack of concrete economic evidence, my fear is that, at best, position limits are a cure for a disease that does not exist or at worst, a placebo for one that does." ▮