



What Does China's Growth Portend for Latin America?

By Megan Davy

Latin American countries have made painful but important economic policy adjustments over the past twenty-five years to open their economies to the global market, resulting in solid growth in most countries. At the same time, governments there have not paid proper attention to their own domestic business environments, key components to their economic health in an increasingly interconnected world economy. China's emergence as a competitor, investor, and customer throws the region's strengths and weaknesses into sharp relief, presenting both challenges and opportunities for Latin America's economic trajectory—and for the U.S. relationship with the region. Governments must now get serious about boosting the region's competitiveness and allaying domestic fears that free trade only benefits a select few. They must also resist the notion that Latin America can replicate China's economic success by adopting Chinese methods of state economic intervention.

China's economy has exploded since it began opening up its state-run economy in 1978, with annual GDP growth averaging around 9 percent. Over the same period, growth in Latin America sputtered at around 2.5 percent per year, plummeting to a low of -2.1 percent in 1983. While China's growth came from liberalization, industrialization, and the resulting "catch-up" growth, Latin American countries made their most significant gains in industrialization in the 1960s and 1970s, under regimes of protectionism, import substitution, and subsidies. These distortions came to a head in the 1980s and led to a "lost decade" of negative GDP growth as countries made difficult adjustments.

These experiences contributed to very different ideas on either side of the Pacific about the proper role of the state in improving international competitiveness. China began liberalizing its command economy by encouraging export processing. The government created incentives to import raw materials and transform them into

finished products. These enterprises gradually attracted foreign direct investment, while the government continued to protect the less-competitive firms (often state-owned) that served the domestic market.

Latin American governments, by contrast, demonized intervention in markets, privatizing most state-owned enterprises and lifting trade barriers beginning in the 1980s. Their economies recovered and began growing again—albeit less quickly than China's—and the competitiveness of export-oriented firms was uneven. While they were focused on restoring macroeconomic stability, most Latin American countries were unable to muster the political and economic will to enact urgent institutional reforms. As such, Latin American firms producing for both domestic and export markets still face formidable hurdles, including corruption and stunted rule of law, limited access to credit, inadequate and unequal education for the potential workforce, and insufficient infrastructure. To be sure, China will have to make its own painful institutional adjustments that could stunt future growth, but in as much as

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its recent policy has focused on fostering an export market thanks to heavy investments in infrastructure and access to subsidized credit, it may serve as an instructive model for examining Latin America's future in an increasingly global economy.

China's emergence in the world market is an instructive foil in highlighting opportunities and challenges for Latin America's economic future. Two concurrent phenomena merit attention. First, China and Latin America are in roughly comparable stages of development (the World Bank classifies China as "low-middle" income and most Latin American countries as "lower-middle" or "upper-middle" income) and therefore are roughly comparable in terms of what we should expect. Second, and no less important, China and Latin America went from a situation of very little economic interaction (including relatively little overlap with third-party countries) to one of increasing economic and political closeness, both with each other and a growing network of intertwined markets.

Mexico and Central America have built a substantial portion of their productive economies on the same stage of the production process that China excels in—but without the global comparative advantage.

In this light, we see two Latin Americas emerge, both plagued by truncated reforms, yet exhibiting very different responses to China's emergence—in many cases, geographically distinct responses. One group of countries, mostly South American, has exploited its possession of important natural resources and their derivatives to sell to an increasingly resource-hungry giant. As China's needs drive a commodities boom, profits have exploded for these nations, and they view deepening economic relations with the Asian giant as largely positive. The commodities boom, however, masks inherent risks in dependence upon a volatile and largely low-skill sector for long-term economic growth and prosperity. The other Latin America, largely comprising Mexico and Central America, has found itself producing an export basket that is very similar to that of China and that is increasingly losing its hold on the market.

For both Latin Americas, China's emergence should be a wake-up call to political leaders to focus on their

investment climates and take action to remedy the market failures that constrain economic growth. Latin America's economic health is of vital importance to the United States as well because of mutual interests related to security, immigration, and trade. The challenge China poses in Latin America should spur the United States to increase its economic engagement in the region.

China: Strategic Competitor for Latin America

At first glance, Latin America and China should not be in direct competition. Latin America is land-abundant, which has given the region a strong advantage in natural resource-based products, while labor-abundant China is more competitive in manufacturing. Latin America is also more capital- and skill-abundant, further separating the two countries in terms of expected production and exports. As such, China and Latin America ought to be specializing in different products with regard to international trade.

However, it is only by comparing Chinese *regions* with Latin America that the true nature of the competition becomes visible. National per-capita GDP in China was around \$1,700 in 2005—about the same as that in Bolivia, Haiti, and Nicaragua. But per-capita GDP on the coast and in the cities, where almost all Chinese exports are produced, is more than three times the national average, making these areas comparable to Venezuela, Chile, and Mexico.¹ Similar patterns exist for illiteracy, a proxy for human capital. While adult illiteracy in Latin America hovers around 10 percent, illiteracy rates in China range from less than 10 percent in the five wealthiest provinces to over 20 percent in the five poorest.² Those areas of China that look like Latin America in terms of capital and skills are the same ones that produce the bulk of China's exports. As a result, these regions in China are equipped with a similar toolbox of labor, skill, and capital and may therefore be able to produce a similar basket of goods—comparable even in terms of quality and sophistication.

This is most significant for Mexico and much of Central America because they have focused so heavily on low-skill, labor-intensive industries as a motor for growth and employment. Many of these businesses import components for electronics and apparel for assembly and subsequently reexport them to the United States, thereby avoiding the regular tariffs structure. In other words, Mexico and Central America have built a substantial portion of their productive economies on the same stage of

the production process that China excels in—but without the global comparative advantage. This strategy made sense in terms of the region's comparative advantage with the United States—that is, low-skill, labor-abundant production—but China's rise calls into question the long-term viability of Mexico and Central America's strategy.

Analysis of shares of the U.S. import market confirms this production convergence. Aggregate data for Latin America support the previous assertions regarding taking advantage of natural endowments in land, skill, and capital; Latin America has relatively high market shares in resource-based products and commodities, while China has a large and growing share of manufacturing products. But the breakdown by country shows that Mexico is the most similar to China in terms of exports to the United States (while Chile's natural resource-based economy is the least similar), and its export basket is also converging with that of China.³

The *maquiladora*—product assembly—industry in Mexico and Central America is competitive today thanks to high U.S. tariffs and duties on these manufactured goods from other countries. These arrangements have protected low-skill, labor-intensive industries from competition with Chinese firms, allowing them to employ more workers at higher wages than would otherwise be possible. Wages in the *maquiladoras* are much higher than in the rest of the economy. In Honduras, for example, the average annual income in *maquiladoras* is \$4,232, while GDP per capita is less than one-fifth that amount.⁴ Textile and apparel production is responsible for 700,000 jobs in Mexico alone, and this sector comprises 20–30 percent of total manufacturing employment in El Salvador, Honduras, and Nicaragua.⁵ *Maquiladoras* form a substantial portion of the economy.

This point is further confirmed by studies on market loss by sector. Latin America's highest losses during the period of protection, between 1990 and 2002, were in resource-based exports, while manufacturing exports to the United States remained largely intact.⁶ While comprehensive analysis of the post–Multifiber Arrangement period that eliminated all textile and apparel quotas in January 2005 is still pending, initial export statistics suggest a bumpy road ahead. In 2006, exports from the six Central American Free Trade Agreement (CAFTA) countries to the United States fell by 7 percent; in El Salvador, they fell 12 percent.⁷ The future of manufacturing in CAFTA and North American Free Trade Agreement countries is under threat.

But lower wages and higher productivity growth in China are not the only factors at play. Latin America's

lagging infrastructure development is a major part of the increased costs of doing business. Electricity costs two to three times as much as it does in China. Proximity to the U.S. market is one of Latin America's natural advantages, but inefficient port facilities and other transportation infrastructure greatly diminish this edge.

Is there a future for manufacturing in Latin America, particularly in apparel and textile production? The answer is a qualified yes. If the Mexican and Central American governments improve their transportation infrastructures and cut electricity costs, they can help their producers compete with China's low-cost, high-volume production—and these investments would produce dividends for all firms trying to do business in the region. Textile and apparel firms would do well to focus on vertical integration and quick turnaround to take advantage of their proximity to the United States. For example, they should aim not only to assemble products but also to offer one-stop shops that supply the fibers and fabrics as well. All told, however, the textile and apparel industry will likely never enjoy the growth that it did in the 1990s. And if nothing is done, the risks posed by Chinese competition to Latin America's manufacturing exporters will only continue to grow.

What Can Latin America Sell to China?

While the future is bleak for some Latin American manufacturers, some of the losses can be offset by identifying market opportunities to sell more goods and services to China itself. The commodities-based export market of South America has already seen a significant boost in exports to China. As per-capita GDP rises in China's coastal and urban areas, the 500 million consumers who live there are increasingly looking for foreign goods. Latin America is well positioned to supply the more diverse agricultural products, processed foods, and tourism services that they are demanding.

Brazil is perhaps best poised to serve this new consumer market. It already supplies China with \$1.7 billion in agricultural products, which equals 8 percent of Brazil's total agricultural exports, with soy constituting 90 percent of the total.⁸ As the palate of urban Chinese consumers moves away from grains and toward meat, milk, oils, and processed food, Brazil's trade will likely expand and diversify.

Latin America is also an important producer of many of the commodities that China needs to fuel its heavy industries. China looks to the region for copper, oil,

iron ore, and lumber, and trade for these commodities has grown remarkably. Exports from Latin America and the Caribbean to China have jumped from \$1.5 billion in 1990, doubling to almost \$3 billion by 1995, reaching \$5.4 billion in 2000, and then growing 42 percent a year between 2000 and 2004 to over \$21 billion in 2004. Primary resources comprised 45.5 percent of the basket in 2003.⁹

Chile, which, in 2006, was the first Latin American country to sign a free trade agreement with China, is also well placed, principally because of its copper production. Between 1996 and 2005, Chilean mineral exports jumped from 61.5 percent of Chile's export basket with China to 83.5 percent by dollar value.¹⁰ While it is difficult to argue against increasing trade, building an export strategy around a comparative advantage in natural resources exposes countries to the ups and downs of the commodities market. Temporary high prices can encourage overinvesting in extraction while neglecting the development of high-skill industries.

Unless Latin American governments get serious about treating the underlying issues and addressing critical market failures, the region will continue to struggle against increasingly competitive regions.

While Chile's export basket is heavily weighted toward extractive industries, the country still may serve as a positive example for those looking to "graduate" from low-skill, low-value-added extractive or agricultural production into a more dynamic production strategy. For example, Chile has developed a high-tech component for its fresh-fruit export market by using biotechnology research and marketing. But these efforts are part of a larger strategy to diversify its export basket and equip small and medium-sized enterprises to compete in a global market. Chile hopes to see significant increases in agricultural exports to China—which currently face high tariffs—and in agricultural byproducts such as wine, nonalcoholic beverages, and cosmetics aimed at the growing Chinese middle class.

The export basket for Latin America as a whole is increasingly diverse and sophisticated: whereas high- and medium-tech products comprised 2.4 and 8.4 percent of the total export basket in 1999, these numbers jumped

to 10.2 and 11.7 percent, respectively, in 2003.¹¹ While encouraging, this news should not be interpreted as "mission accomplished" for the region, as Chinese exports are undergoing the same transformation. Now more than ever, policymakers need to address the obstacles that continue to thwart the region's advancement.

How Governments Should Respond

How does economic development policymaking in Latin America need to change in order to mitigate the risks and seize the opportunities that China presents? First, Latin American governments should avoid the temptation to reverse twenty years of liberalization and "hands-off" policy—by reverting to the protectionism and favoritism that plagued the region in previous decades or by searching for a new brand of government control in the form of "Bolivarian socialism" as Hugo Chávez and his allies have been demanding, and doing, in the countries they control. Chinese-style development spending is no panacea either, as China's methods are dependent upon economic distortions that Latin America can ill afford to adopt, such as excessively high savings rates (resulting in less household consumption, even in very poor homes), an increasingly insolvent state-owned business sector, costly duplicate investment in certain industries, and a rise in income inequality. Seemingly more benign forms of government intervention, including but not limited to public banking services to boost access to credit or funds to attract foreign firms and investment, are often only a temporary patch for serious underlying institutional deficiencies. Unless Latin American governments get serious about treating the underlying issues and addressing critical market failures, the region will continue to struggle against increasingly competitive regions.

For example, Latin America has underinvested in human capital, especially education. Governments have subsidized postsecondary education heavily while largely ignoring secondary education, resulting in low enrollment and substandard performance in international assessments. The poor quality of secondary education threatens the region's ability to create high-skill jobs, particularly those that require skills in math, science, and engineering.

Similarly, a longstanding political preference for urban development has resulted in a bias against investments in rural infrastructure, where 40 percent of Latin America's poorest citizens reside. Agriculture has stagnated without reliable access to electricity and other

resources and without links to domestic or international markets. As a result, in many of the poorest areas, farming continues to be largely for subsistence, despite a greater demand for more sophisticated agricultural products that would boost rural wages. Without greater investments in transportation infrastructure, electricity, and communications, rural farmers will be unable to compete in global markets.

Without important reforms to property rights and rule of law—including but not limited to clear regulations on licensing, contract enforcement, and investment protection—domestic and foreign investors alike will continue to shy away from setting up shop in the region.

Research and development (R&D) faces similar obstacles. The high costs and attendant risks in the R&D process lead to underinvestment in innovation by the private sector. Increasing funding for research capabilities in universities can strengthen links between higher education and industry. R&D of this type allows countries to seize comparative advantages while creating new opportunities in high-tech sectors. Strengthening the enforcement of intellectual property rights is also a means of attracting investment in innovation.

Finally, without important reforms to property rights and rule of law—including but not limited to clear regulations on licensing, contract enforcement, and investment protection—domestic and foreign investors alike will continue to shy away from setting up shop in the region. This is especially true of small and medium-sized firms that cannot exert political pressure to overcome the obstacles to starting and running a business.

The U.S. Stake in Latin America's Future

Free trade is in the interest of both the United States and Latin America. But a country can take full advantage of the benefits of free trade only if it has the right infrastructure, skills, and laws. Bilateral relations between the United States and Latin American countries have many facets, but the preponderance of U.S. spending and diplomatic engagement there tends to focus on counternarcotics and

trade agreements. In doing so, the United States implicitly de-emphasizes other areas of common interest, such as immigration, gang violence, poverty reduction, and the consequences of China's expanding global reach. This approach may, in fact, have slowed momentum on expanding free trade throughout the Western Hemisphere, as evidenced by stiff resistance from many Democrats in Congress to new trade agreements.

The current priorities also overlook other mutually beneficial contributions that the United States could make to the region's economic growth, such as support for economically productive infrastructure development and for economic freedom. One important new tool is the Millennium Challenge Corporation (MCC), a U.S. agency that promotes economic growth in poor countries with an emphasis on sound governance, economic freedom, and human capital. The MCC compact in Honduras, for example, works with small and medium-sized farms to increase capacity through technical assistance, improved infrastructure, and better access to credit. The U.S. Agency for International Development's institutional reform and economic growth programs, while of good technical quality, are grossly underfunded.¹² But the level of U.S. spending in these areas through all existing mechanisms is far too low to be transformative.

No less important is a critical examination of domestic U.S. policies that have pernicious effects on growth and well-being in Latin America. U.S. agricultural subsidies, which are greatest for crops such as sugar, fruits, and vegetables—precisely the crops that Latin American countries are best suited to grow—put foreign imports at a disadvantage. Furthermore, by protecting corn-based ethanol producers, the United States sends the wrong signal to sugar-based ethanol producers in Brazil, hampering agricultural modernization and innovation in high-tech biofuels.

The necessary investments and reforms will be difficult for both U.S. and Latin American governments. In many areas—such as corruption and the rule of law—China will face similar challenges on its path to continued economic growth. But by looking at some of the lessons of China's emergence in international markets and examining their own domestic business environments, Latin American governments can identify key reforms to stay competitive. By expanding its set of policy priorities, the United States can play an important role in this transformation.

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Notes

1. Author calculations are based on International Monetary Fund, *World Economic Outlook Database*, October 2007, available at www.imf.org/external/pubs/ft/weo/2007/02/weodata/index.aspx (accessed December 14, 2007); and People's Republic of China, State Statistical Bureau, *China Statistical Yearbook*, 25th ed. (New York: Praeger, 2006).

2. Data for Latin America and the Caribbean are from Economic Commission for Latin America and the Caribbean, Social Indicators and Statistics (BADEINSO), *CEPALSTAT*, available at <http://websie.eclac.cl/sisgen/ConsultaIntegrada.asp> (accessed December 28, 2007). Data by Chinese province are from Robert Devlin, Antoni Estevadeordal, and Andrés Rodríguez-Clare, eds., *The Emergence of China: Opportunities and Challenges for Latin America and the Caribbean* (Washington, DC: Inter-American Development Bank and David Rockefeller Center for Latin American Studies at Harvard University, 2006), 93. Autonomous regions are excluded from calculations.

3. Robert Devlin, Antoni Estevadeordal, and Andrés Rodríguez-Clare, eds., *The Emergence of China: Opportunities and Challenges for Latin America and the Caribbean*.

4. Manuel R. Agosin, Pablo Rodas Martini, and Neantro Saavedra-Rivano, "The Emergence of China: A View from Central America" (Economic and Sector Study Series RE2-04-006, Inter-American Development Bank, Washington, DC, October 2004). The authors note that the GDP of Honduras is "very much underestimated (perhaps by as much as 40 to 70 percent) by the official national accounts."

5. Robert Devlin, Antoni Estevadeordal, and Andrés Rodríguez-Clare, eds., *The Emergence of China: Opportunities and Challenges for Latin America and the Caribbean*, 177.

6. Mauricio Mesquita Moreira, "Fear of China: Is There a Future for Manufacturing in Latin America?" (background paper, Integration Department, Inter-American Development Bank, Washington, DC, October 2004).

7. Helen Murphy, Christopher Swann, and Mark Drajem, "China's Power Erodes Free-Trade Support in Developing Nations," Bloomberg, April 2, 2006.

8. Robert Devlin, Antoni Estevadeordal, and Andrés Rodríguez-Clare, eds., *The Emergence of China: Opportunities and Challenges for Latin America and the Caribbean*, 128.

9. Economic Commission for Latin America and the Caribbean, "Aspectos estratégicos de la relación entre China y América Latina y el Caribe," in *Panorama de la inserción internacional de América Latina y el Caribe, 2004: Tendencias 2005* (Santiago, Chile: Economic Commission for Latin America and the Caribbean, 2005).

10. Government of Chile, General Office of International Economic Relations, "Tratados de Libre Comercio Chile-China" (document prepared for the General Office of International Economic Relations, Ministry of International Relations, Santiago, Chile, May 2006), 15, available at www.direcon.cl/documentos/China2/documento_china_final_agosto_2006.pdf (accessed December 14, 2007). Some of this increase may be due to increased copper prices over the last several years.

11. Economic Commission for Latin America and the Caribbean, "Aspectos estratégicos de la relación entre China y América Latina y el Caribe."

12. Even these programs tend to exclude the poor regions of middle-income countries, such as northeast Brazil and southern Mexico—the places where economic growth and economic freedom are most urgently needed.