Development Centre Studies

The Rise of China and India: What's in it for Africa?

Summary in English

This publication results from the Development Centre's Programme of Work 2005-2006, in the context of its broader mandate to facilitate informal policy dialogue between the OECD and non-member countries. It is part of research activity *Policy Coherence and Productive Capacity Building*.

The study has been developed in co-operation with the German Development Institute, Berlin, and the Institute for Development Studies, Sussex University. Earlier drafts of this study have been presented and benefited from comments at the African Development Bank, the Bank for International Settlements, Basel University, the EU Ecowatchers Group (Abuja), the Global Development Network, and the Nigerian Institute for International Affairs.

With the emergence of China and India in the world economy ever more manifest, Africa's economy and polity will be affected in various, complex ways. The interactions between the Asian giants and Africa are bound to intensify even if the recent period of supercharged growth in the former countries is unlikely to be sustained.

The Asian giants are relevant for policy design by African governments in many ways; we can think of the Asian giants as growth models, key global price setters, including for interest rates, potential markets, competitors, financiers, and polity determinants. Policy interactions seem relevant in the areas of raw material price levels and volatility, exchange rate developments and resource allocation (de-industrialisation, vertical integration), low-wage competition and income distribution, industrialisation strategies, input linkages (in China and India), capital-flow effects (such as through FDI, project finance, public-private joint ventures), finally the context of widely rent-seeking behaviour and ethnic distribution tensions.

As the present study amply documents, African economies are affected differentially by the competitiveness and growth of Asia. In some cases, there may be complementary effects, as producers benefit from the demand for their outputs from Asia. China and other countries may even want to secure raw materials and improve export infrastructure in selected African countries and offer project finance, FDI and other forms of trade-linked capital flows. In other cases, interests may be competitive rather than mutual, as Asian economies divert indirectly investment resources away from African economies.

While on balance the short-term opportunities of Asia's ascendancy and of corresponding South-South trade may outweigh the economic cost for Africa, in particular its raw material and energy exporting economies, there are serious long-term risks. These risks are related to weak governance standards which may lead to misallocation of receipts stemming from higher raw material prices and from disincentives for investment in non-traditional tradable activities, needed for better sharing the benefits of global trade.

With the integration of China and India – the "Asian Drivers" – in the world economy gaining momentum, it is ever more manifest that economy and polity in poor countries will be affected in various, complex ways. The sheer size of the Asian Drivers, their phenomenal rate of growth, their hunger for natural resources, and their growing economic and political power ensure that they will re-shape the world economy and influence the rules of the game. Their growing presence is likely to transform past relationships in a number of key respects, providing both competition and opportunities not just to the major trading partners in OECD countries, but also to developing countries and other emerging economies. Therefore, innovative policy responses to the Asian Drivers have to be devised. And they will be needed for the long term, as the giants' rise is unlikely to be only transient.

Through this work, the OECD Development Centre aims at inform policy decisions and strategies that maximise the benefits and minimise the risks that arise for African countries and people from the ascendancy of the two Asian giants.

The emphasis here is on global macroeconomics, raw commodity markets, trade links and policies, foreign direct investment (FDI) by Chinese and Indian multinationals, and governance standards. In particular, given the fact that most African economies are linked to the world economy as raw material producers and hence important suppliers to the Asian Drivers, the paper focuses on the role of China and India on some international commodity and energy markets. The paper:

- starts with the indirect global macroeconomic effects that arise from China's and India's growth performance on raw material markets, through which Africa's economies are most prominently linked to the world economy;
- looks at terms-of-trade effects that arise as a result of lower manufactured goods prices, higher raw material prices and trend exchange rate appreciation of the Asian giants, in order to explore possible allocative consequences (the so-called Dutch Disease effects);
- traces the redirection of African trade towards China and India and identifies the corresponding policy challenges that arise from the fact that China and India are 'swing importers' in certain raw material markets;
- takes a close look at corporate players as conduits of FDI flows between China, India, and Africa and analyses how Africa multinationals (although essentially those from South Africa) can benefit from market opportunities in the Asian Drivers.

Ultimately, the book aims at informing donor policy choices as to appropriate macro policies to minimise Dutch Disease effects (should any arise), sectoral diversification strategies, trade policy recommendations (such as how to deal with preference erosion in the wake of the dismantling of the Multi-Fibre Agreement), and host-country policies best suited at maximising and sustaining the benefits from FDI.

The Asian giants' integration into the world economy has dramatically changed the nature of macroeconomic and financial interdependence; this, in turn, shapes primary commodity markets.

First, China and India are rapidly integrating their huge labour forces into the world economy and growing swiftly. Each year since 2001, their combined contribution to global output growth has been around 30 percent. Moreover, this contribution has helped to hold world growth above the 4 percent threshold which is critical for improving the terms of trade for primary commodity producers. On the financial front, demand from Asian investors, in particular the recycling of foreign exchange reserves into US securities – the Asian bid – has contributed to the low level of US interest rates which have further stimulated raw material prices.

Consequently, Africa – still largely connected to the world economy through raw material exports – is benefiting from the China-driven 'super cycle', which is reinforced by India's emergence.

The growth of Africa's exports is narrowly correlated with the growth of its major commodity exports – oil, industrial as well as precious metals, tropical woods, and cotton - to China and India. Africa is linked to the Asian drivers' demand for primary commodities via two channels, namely through raw material prices (which are increasingly governed by China's net import demand) and through the growing trade dependency of Africa on China and India. Africa's income terms of trade may well have benefited from Asia's emergence as a net rise in the demand for raw commodities has translated into higher export unit prices, and as urban consumers gain from cheaper consumer goods and investors benefit from cheaper capital goods. The benefits of China's and India's rising global demand (net imports) for Africa-relevant commodities are, nevertheless, attenuated by the volatility of demand of the Asian giants, partly due to cyclical variations but also to arbitrage between home production and imports.

Moreover, China and India's growing demand for commodities has brought about a significant redirection of African exports towards Asian markets – away from OECD markets, even though Africa-China and Africa-India trade patterns are quite different. Chinese imports from Africa show a very clear pattern in terms of commodity structure which is consistent with the latter's Ricardian advantage in commodity production. By contrast, African exports to India are much more diversified and labour-intensive than those to China. Nevertheless, Africa's trade reorientation may also hold some drawbacks. First, it may derail the endeavors by African commodity producers to diversify away from traditional exports. Second, shortage in world shipping capacities and the rise in freight rates charged to commodity exporters and importers is drawing ships into the Pacific and may drive up shipping rates, to the detriment of African competitiveness.

Deepening the reliance on commodity industries has been shown to be at odds with poverty reduction. Third, increased presence of the Asian giants in the resource rich countries may increase the rents earned by an elite that commands access to those resources, rather than by the population at large. It is important to note, however, that transparency scores have *not* deteriorated during recent years when the presence of the Asian giants became more visible in Africa.

As China and India are currently integrating more than one billion people into the global labour pool, competition is intensifying in tradable labour-rich goods, the relative prices of which are dropping. However, labour-intensive manufacturing industries are less prominent in Africa than in other developing regions; and urban consumers benefit from the higher purchasing power of their incomes thanks to lower prices for labour-rich goods. To be sure, such analysis ignores opportunities for diversification away from traditional exports, i.e. potential rather than actual competition. Imports of specific products from China and India may indeed be damaging for some local producers, especially labour-intensive local industries such as garment, thus impairing the development of nascent non traditional industries and putting diversification prospects in jeopardy.

In order to avoid being trapped into the unpromising corner of vulnerable, capital-intensive and high-risk raw material dependence, resource-rich Africa will have to balance the need to match the promotion of job-rich sectors with the desire to capitalise on a windfall gain generated by higher commodity prices. Monetary authorities will have to lean against the real currency appreciation in order to avoid burdening industries competing with imports, and exporters outside the resource sector. Central banks need to be supported by fiscal authorities, which are required to limit public spending on services and construction to keep non-tradables prices in check. Investment abroad of export proceeds will further insulate the local economies from 'Dutch Disease' effects.

Furthermore, in low-tech activities like clothing or footwear, growing FDI into China and India is likely to crowd out investment in Africa, although geography and preferential tariff treatment may still provide some African countries with a competitive edge. Head-on competition, however, is unlikely to be the main channel through which the Asian drivers impact on FDI flows into (and out of) Africa. The first and foremost one is throughout increased international prices for oil and other natural resources, which underline the current dynamism of cross-border investment in this broadly-defined sector. Moreover, FDI from the Asian giants is growing, especially but not solely in the petroleum industry. Last but not least, the growing presence of South African multinationals in China and India is also noteworthy: the Asian Giants FDI story is not a one-way street.

Finally, the study has shown that on balance quantifiable effects of the Asian Drivers' rise in the world economy are largely positive for Africa. This neither implies that those benefits will persist, nor that they lay the ground for better economic performances on the continent. While those effects are positive for Africa, their interaction with a number of *future policy challenges* – governance standards, diversification, back- and forward linkages between modern-sector enclaves and the rest of the economy, labour absorption and skill formation – merits careful policy attention.

In this context, African policy-makers, donors, and the business community should devise appropriate policy responses along these three main axes:

- First, considerable room for improvement exists with respect to exploiting African natural resources in a sustainable manner. Making the case for diversifying African economies should not indeed prejudice a more efficient exploitation of available natural resources on the African continent, especially once African relative factor endowments are factored in.[1]
- Second, African diversification and trade strategies should be rethought in light of increasing Chinese and Indian competition in sectors which used to be regarded as potential avenues for Africa's diversification.
- Third, donors' support, in particular in the realm of "trade as aid", should be enhanced so as to facilitate African economies' adjustment to rising Chinese and Indian competition