China's Free Trade Agreements in South America

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SHAPING POLICY DEBATE FOR ACTION

China's phenomenal rise has emerged as one of the three most prominent trends in Latin America, along with the collapse of regional and multilateral trade negotiating venues since 2006, and South America's quick economic recovery from the 2008–09 global financial crisis. These developments have influenced policy choices over the past decade, although the variety of paths taken confirms the importance of domestic political and institutional arrangements in shaping policy outcomes.

Since 2000, China has evolved into the first or second most important trading partner for Argentina, Brazil, Chile, Costa Rica, and Peru. Buoyant trade with China enabled those countries to accumulate large reserves which, in turn, facilitated a counter-cyclical policy response when financial shocks from the United States hit the region in 2008. Moreover, between 2003 and 2009, Chinese foreign direct investment (FDI) in Latin America reached US $24 billion, up from basically nothing at the outset of the 2000s. The ability of these countries to rebound by late 2009 also reflected the important banking and financial sector reforms undertaken in South America since the 1990s.

There was also a degree of luck at work here as China's voracious demand for South America's natural resources kicked off the region's largest commodity boom in a century. As a result, prices and demand for Argentina's soybeans, Brazil's iron ore, Chile's copper, and Peru's copper and fishmeal have held steady since 2003. Despite more recent volatility in commodity prices, current forecasts suggest that China-driven growth for all but soybeans may still exceed 10 percent annually until 2020. Some South American countries, in other words, are set to cruise quite comfortably over the next decade.

Yet, history tells us that such commodity booms, not to mention the overall pattern of old-fashioned comparative advantage that has characterized the 2000s in South America, will inevitably end in tears. As at the turn of the last century, today's boom in commodity sales to China has been offset by the import of manufactured and intermediate capital goods from China. But this time around the nature of those goods being imported from China is higher in knowledge content, value-added and technological inputs, and China accounts for a steadily increasing share in these domestic markets. Whereas the earlier experience with this pattern of trade invoked policies of import substitution and a widespread critique concerning the unfavorable terms of trade for the region, the structural conditions that now prevail within most of these economies are quite different.

Because of considerable inroads made with industrialization, the promotion of non-traditional exports, and the diversification of trade partners, the terms of trade have basically held steady for these Latin American countries (with the exception of Chile). What has not held steady, however, is the ability to keep pace with the competitive gains of China's manufacturing sector over the past twenty years—advances that result from focused expenditures and policies since the early 1980s to promote science, technological adaptation, advanced education in hard science fields, and research and development. There is, thus, a growing conviction among

FOREWORD

The Inter-American Dialogue is pleased to publish this issue brief prepared by Carol Wise, associate professor of international relations at the University of Southern California. An expert on international political economy and development, Wise has written widely on trade integration, institutional reform, and the political economy of market restructuring in Latin America, and is currently completing a book entitled *China, Latin America, and the End of Neoliberalism*. Wise is also co-editing a collection of essays with the Inter-American Dialogue on "The Political Economy of China-Latin America Relations" to be published in 2013.

Wise's paper on China's free trade agreements with Chile and Peru is the first in a series of economics briefs that will published by the Inter-American Dialogue's China and Latin America Program in coming months. China's slowing growth, its proposed "economic transformation," and its commitment to deeper economic integration with Latin America are changing the landscape of China-Latin America economic engagement. Latin American nations, meanwhile, have adopted strikingly different approaches to managing China's expanding economic influence in the region. The Dialogue's China and Latin America economics briefs will address areas of emerging interest at this pivotal moment in China-Latin America economic relations. In addition to Wise's assessment of Chinese FTAs in South America, our contributors will address such topics as China's approaches to *renminbi* internationalization in Latin America, China Development Bank policy, commodities-related trends in the region, and China's influence on Latin American industrial policy.

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Latin American countries that they must try harder to export non-traditional, higher-value-added products to the Chinese market. Yet, cost, geographical, and growing technological disadvantages make this unlikely, at least in the near future.

Rather, this is a time for Latin American countries to take stock of their export and production capabilities and to develop a strategy to enhance their overall competitiveness in regional and world markets. At a minimum, this would require articulation of a longer-term vision around the development of a stronger domestic productive capacity, specifically one that is based on higher spending allocations in science, technology, R&D, education, and infrastructure. Chile and Peru have gone so far as to negotiate separate bilateral free trade agreements (FTAs) with China as a way of coping with these competitive pressures. While no panacea, these FTAs have reduced trading tensions with China and helped rationalize manufactured imports from China in ways that benefit domestic producers.

China's FTAs with Chile and Peru

There are two key factors to keep in mind when analyzing Chile's and Peru's FTAs. First, both agreements deal primarily with the World Trade Organization's "old trade agenda" around market access. This refers to the quest to liberalize agriculture and markets for lower value-added manufactured goods. The bulk of these FTA negotiations with China dealt, therefore, with the extent of product coverage for liberalized tariff lines, the timelines for liberalization,

and the reduction of policies deemed most detrimental to market access. Second, Chile and Peru had each negotiated a free trade pact with the United States prior to finalizing their agreements with China. The US agreements were weighted more heavily toward the "new trade agenda," which addresses the deregulation and liberalization of services and investment, as well as stronger protection of intellectual property rights.

The US FTAs, including the recently finalized Colombia-US FTA, seek to raise the economic competitiveness of both signatories through the harmonization and modernization of services and investment, while the FTAs with China seek to cushion the blows of adjustment for traditional manufacturing and agricultural producers. Both the Chile-China (2006) and the Peru-China (2009) FTAs cover items on the new trade agenda. However, the exceedingly low investment levels and the limited exchange of services between China and these two countries suggest that these China FTAs will pertain to the old trade agenda for some time to come.

The Chile-China FTA, for example, provided immediate duty-free entry for 92 percent of Chile's exports to China. Copper currently represents 84 percent of Chile's exports to China, leaving Chile anxious to diversify. Chilean negotiators succeeded in covering the most important agro exports (apples, grapes, plums, chicken products, cheese, and cherries) in the FTA. But some of the South American country's most successful agro-industrial exports—fruits and fish—were to be phased in over ten years.

On the import side, 50 percent of Chile's imports from China were granted duty-free access at the outset, although goods in 152 "sensitive product" lines (including wheat, flour, sugar, some textiles, and some major appliances) were completely excluded. China's thirst for Chilean copper was such that it conceded on these exclusions, which represent a mere iota of Chinese exports to the world. China negotiated a long-term contract on Chilean copper purchases within a mutually agreed upon price range. Chilean policy makers, in turn, were able to provide some respite for domestic producers within these sensitive product lines.

A similar pattern played out with the Peru-China FTA. Peruvian negotiators were proactive in reducing tariffs on 99 percent of Peru's exports to China, 83.5 percent of which entered the Chinese market duty free at the outset of the agreement. China excluded goods such as coffee, wheat, rice, corn, sugar, and vegetable oils, which accounted for about 1 percent of the value of Peru's exports.

In return, 68 percent of China's exports to Peru were granted immediate market access. As in the case of Chile, China's demand for copper (and Peru's fishmeal) outweighed its interest in market access for all goods, and Peru was able to negotiate exclusions for 592 sensitive product lines—including textiles, garments, shoes, and metal mechanics—that account for about 10 percent of China's exports to the South American nation. For China, the economic stakes around these products were low. For Peru, the exclusions were considered a political victory.

Preliminary Insights on China's South American FTAs

It is no coincidence that China finalized FTAs with two small, open economies with negligible industrial sectors while larger industrial economies like Argentina and Brazil bristle at the idea of such an arrangement. For Chile and Peru, the future lies not only in the continued expansion of primary exports but also in the rapid modernization of related services: shipping, transport, insurance, banking, finance, etc. It is most likely that the US FTAs will speed both countries' emergence as service hubs for trans-Pacific trade, a role to which they aspire. In contrast, the China FTAs offer medium-term breathing room to accomplish larger goals. On the one hand, large foreign exchange reserves that Chile and Peru have accumulated under the impulse of Chinese demand provided a financial cushion for deeper reforms around the new trade agenda. On the other hand, China's acceptance of some mild limits in accessing domestic manufacturing markets in these countries has reduced some of the heat that political leaders in countries like Argentina and Brazil are still facing.

The pain of adjustment is more palpable under the terms of the US FTAs, but the agreements seem a necessary step for taking small open economies to the next level of development. The China FTAs are neither necessary nor sufficient within this long-term scenario. However, they have provided leeway for countries to undertake reforms, and they have reduced uncertainty during a period of economic restructuring triggered by China's rapid entry into South American markets in the 2000s.

The Inter-American Dialogue is the leading US center for policy analysis, exchange, and communication on issues in Western Hemisphere affairs. The Dialogue brings together public and private leaders from across the Americas to address hemispheric problems and opportunities. Together they seek to build cooperation among Western Hemisphere nations and advance a regional agenda of democratic governance, social equity, and economic growth.

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