

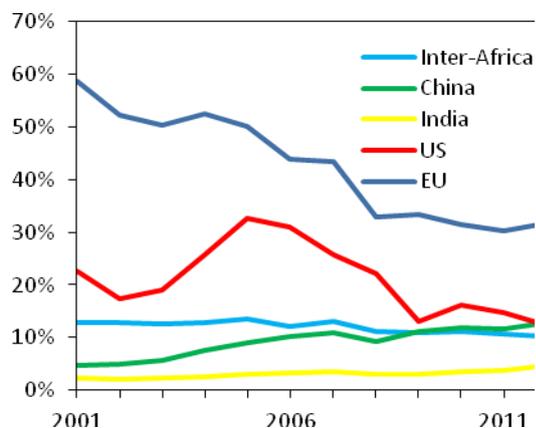


China's changing economy: new opportunities for engagement in Africa?

Summary: China's economic links with Africa have boomed in the last decade. But China's economy is now growing more slowly, and rebalancing towards consumption-led growth. For African commodity exporters, this could have knock-on effect as Chinese commodity demand growth slows. But it could have some upsides: Africa's manufacturing industry will increasingly complement China's, and Chinese investors will be under greater pressure to make sustainable long-term investments. For HMG, it opens up avenues of collaboration in regional trade, infrastructure and energy.

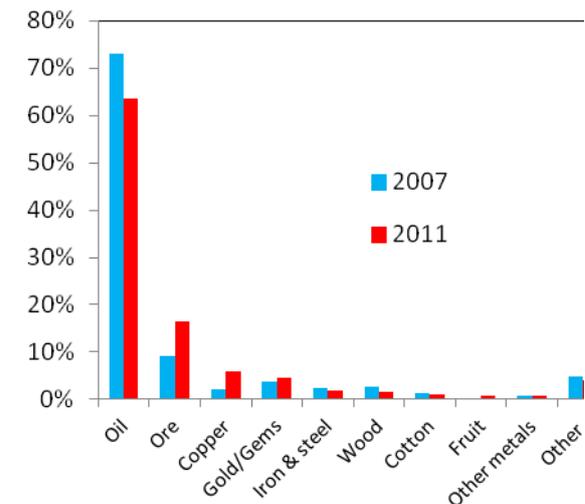
- 1. China has emerged as Africa's largest trade partner.** China has been Africa's biggest market for exports for a while – African exports to China overtook its exports to the US in 2009. But the relationship is increasingly two-way, with Chinese exporters expanding their footprint in Africa in recent years. Since 2012, China's exports to Africa have been larger than any other single country. (See Chart 1)
- 2. China's imports from Africa are largely from resource rich countries.** Oil is Africa's biggest export to China: making up over 60% of total exports. Other raw materials (including ores and gems) make up the bulk of the remainder (see Chart 2). As a result, the top ten African exporters to China are all resource-rich, with Angola's close oil ties putting it ahead of the pack (see Chart 3).

Chart 1: Africa's imports (% of total imports)



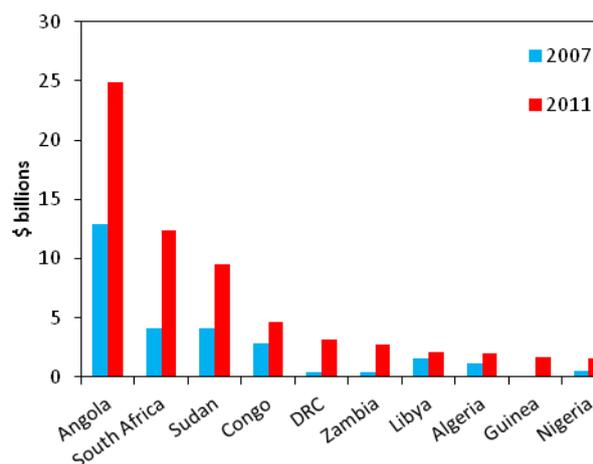
Source: Trade map

Chart 2: African exports to China, by product



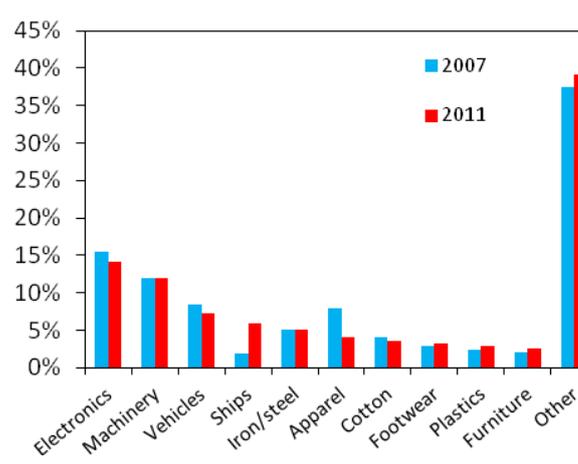
Source: Trade map

Chart 3: African exports to China, by country



Source: Trade map

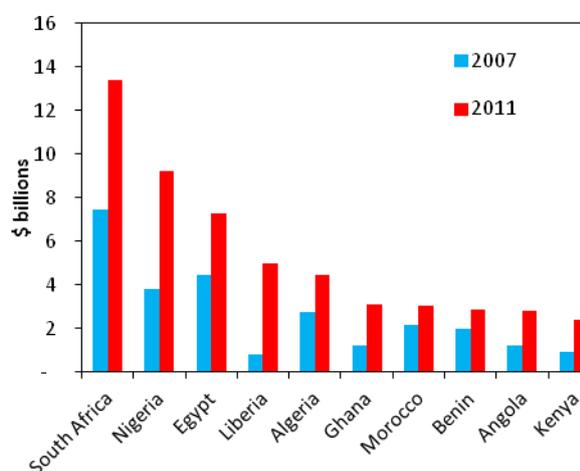
Chart 4: China's exports to Africa, by product



Source: Trade map

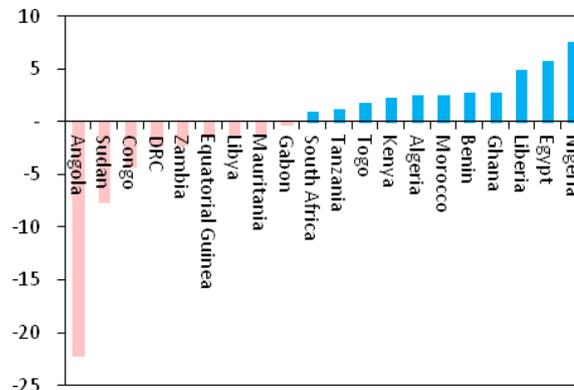
3. Chinese exports to Africa in contrast are focused on Africa's largest and most developed markets. China exports mostly manufactured products to Africa (see Chart 4), with electronics, machinery and vehicles the main exports. South Africa and Nigeria, the two largest economies in SSA, are the main importers of Chinese goods (partly driven by major Chinese construction activities there). Liberia is a surprisingly large import market, but this is largely as a result of imports of ships (stemming from Liberia's flag being used as a 'flag of convenience' for merchant ships). (see Chart 5) The result is a relatively uneven picture of Chinese trade balances with African countries (see Chart 6.)

Chart 5: China's exports to Africa, by country



Source: Trade map, FCO calculations

Chart 6: China's trade balances, \$bn, 2011



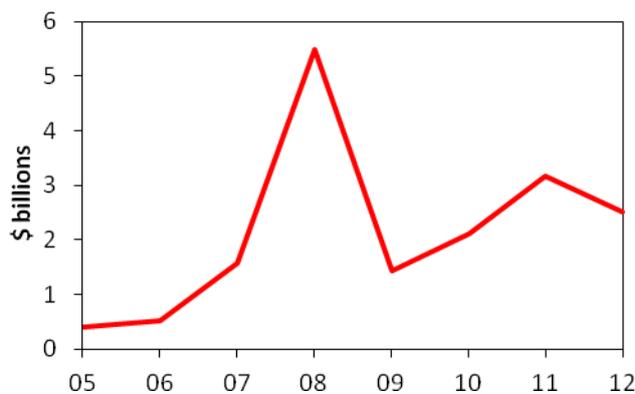
Source: Trade map, FCO calculations

4. But trade is only one dimension of China's economic engagement with Africa – foreign direct investment (FDI) is another. Since 2005, China's FDI stock has increased thirteen-fold, with a total FDI stock totalling \$16bn in 2011 (although not all Chinese investment is likely to be reported in these figures). The magnitude of this should not be over-stated: the UK in comparison had a stock of \$48 billion in 2011, and flows of Chinese FDI have been volatile since the financial crisis. But it still reflects a significant transformation in Chinese FDI on the continent.

5. Chinese FDI in the last decade has been largely focused on resource extraction – but not exclusively so. Analysis of “big ticket” Chinese investments overwhelmingly points towards a focus on energy and metals extraction: energy and metals made up 88% of major Chinese investments in Africa between 2006 and 2012¹. But this masks the activities of smaller Chinese SMEs, who are more focused on manufacturing and construction industries. It also hides targeted Chinese investments into strategic sectors like financial services: for example, China’s largest bank (ICBC) bought a 20 percent stake in Standard Bank in \$5.4 billion in 2008, giving it a stake in financial services across the African continent. Data constraints make the precise numbers hard to predict, but it is fair to say Chinese investment in Africa has been largely, but not solely focused on resource extraction.

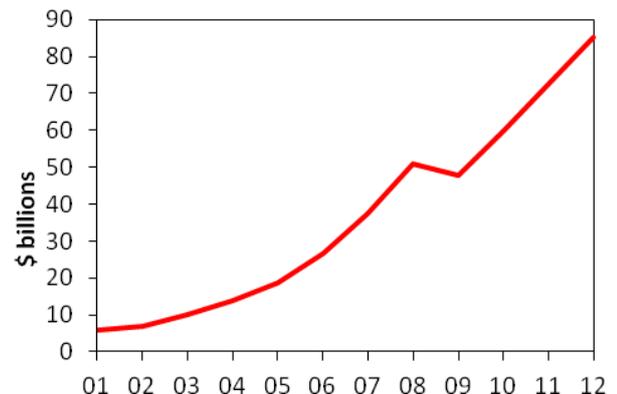
6. The third leg of Chinese economic ties with Africa has been its willingness to provide concessional loans to finance infrastructure projects. China’s Export-Import Bank (EXIM) has emerged as the continent’s biggest financier, lending a total of \$67.2 billion to Sub-Saharan Africa between 2001 and 2010 (more than the World Bank). An estimated 80% of these loans are for infrastructure development, with a particular focus on Angola, Ethiopia, Nigeria and Sudan (pre-2011). This financing is an important driver of business for Chinese telecoms and construction companies: in many cases concessional loans stipulate a requirement for the contract to be provided by Chinese companies, which in turn has driven Chinese investment and import of goods from China.

Chart 7: Chinese FDI flows to Africa



Source: MOFCOM

Chart 8: African exports to China



China

Source: Trade map, FCO calculations

But China’s economy is changing, which could have knock-on effects for Africa...

7. China’s long boom brought big benefits for Africa. China achieved an average growth rate of around 10% over the past few decades. This growth was driven by investment and a focus on resource intensive industries like manufacturing and heavy industry. This translated into booming demand for Africa’s key export: natural resources (see Chart 8). It also incentivised investment from Chinese firms into metals and mining sectors, which in turn drove growth in natural resource production as well as growth in broader economic sectors.

¹ According to the Heritage Foundation, who monitor major Chinese investments across the world

8. **But China's economy is now slowing, and changing its structure.** 10% annual growth in China is unsustainable in the long-term. Returns to investment in China are diminishing over time, so China's investment-led growth can only go on for so long without unsustainable increases in debt. Meanwhile, a combination of rapid economic growth and longer-term demographic change in China has driven rising labour costs, gradually eroding China's competitive advantage in labour-intensive manufacturing.
9. **The Chinese authorities are responding.** Recognising that rapid growth of this kind is now unsustainable, the Chinese authorities are now committed to maintaining GDP growth targets of 7% during the 12th Five-Year Plan, with a range of measures designed to rebalance investment towards consumption. These measures are set to: promote urbanisation (which would help fuel domestic consumption), lower domestic savings (which would in turn reduce Chinese investment) and promote competition (which would reduce the influence of Chinese state owned enterprises).

On the face of it, this could mean trouble for economies in Sub-Saharan Africa...

10. **Firstly, slower, and less resource-focused Chinese growth has resulted in falling commodity prices – hitting African commodity exporters.** Metals prices are down 14% in 2013. Coal prices have fallen too, causing particular problems for companies like Rio Tinto in Mozambique. Oil exporters (such as Nigeria and Angola) have suffered less: China is less of a dominant force in global oil markets in comparison to global metal and coal markets. But the Chinese slowdown – and the possibility of a further deterioration in China's growth prospects does create a threat for African exporters heavily dependent on commodity exports to China.
11. **Secondly, China's economic slowdown (and lower commodity prices) could also limit the willingness of Chinese investors to invest in Africa.** In the last two years, Chinese FDI flows to Africa have stalled a little as China's growth has slowed (see Chart 7) and commodity prices have fallen. Up-to-date data can be hard to come by, but industry reports suggest that Chinese investment in the African mining industry has fallen by 10% in the last year. A prolonged economic slowdown in China could continue this trend, as slower growth at home hits the willingness of Chinese firms – and the Chinese state-owned-banks – to take on risky overseas investments.
12. **Finally, changes in China's economic structure could mean a slight decoupling of Africa and China's economic growth prospects.** In recent years, Africa has provided China with a source of materials needed to fuel its resource-intensive growth. If China successfully rebalances towards consumption, the availability of Africa's resources will not be as critical for China's growth prospects as in the 2000s. The impact of this is hard to predict: but it could arguably diminish some of China's interests on the African continent.

But there could be some upsides...

- 13. Rising labour costs in China may tilt Chinese manufacturing towards complementing, rather than competing with Africa's nascent manufacturing industry.** In recent years, large numbers of Nigerian textile factories closed in the face of Chinese competition. But now, as rising labour and land costs push Chinese manufacturers up the value chain, Africa increasingly offers an opportunity for Chinese firms to take advantage of cheaper African labour costs and invest in labour-intensive manufacturing (and capitalise on the friendly tariff regimes for access into European and American markets). Visible signs of Chinese investment in African manufacturing (eg. shoe factories in Ethiopia) may indicate greater untapped potential for Chinese investment – although infrastructure, power generation and human capital will still be key constraints.
- 14. What's more, growing financial pressure for Chinese firms could push them towards making more savvy, and more sustainable investments.** Perception is growing (including amongst Chinese firms) that insufficient attention has been paid to corporate responsibility and workers' conditions, with a resulting link to poor investment performance: Wang Jiahua, vice-president of the Chinese Mining Association, has been reported as saying that 80% of Chinese investments in mining over the past decade had largely failed. With an economic slowdown squeezing profits and investor appetite at home, Chinese firms (particularly those investing outside the traditional extractives sector) will need to make more careful investments to ensure long-term profitability.
- 15. And although China's economy is slowing and rebalancing towards consumption, it will still need to meet large and growing energy and natural resource needs.** Between now and 2020, China's energy consumption will grow faster than it can expand its energy supply. This burgeoning energy demand will survive the changes in China's economy: China sees urbanisation as a key priority, and energy will be needed to power China's growing cities. Emerging African energy producers in East Africa are already benefitting: in August 2013 China agreed to fund a \$5.2 billion railway line between Mombasa and Nairobi. And producers of raw materials needed for consumption (eg. petroleum for cars, iron ore for construction) will benefit from China's tilt towards consumption.

What does this mean in turn for our engagement with China?

- 16. All of this clearly points towards a more balanced Chinese commercial interest on the African continent in the coming years.** For HMG, this highlights a few potential avenues of co-operation that could be explored in the context of UK-China Africa dialogues:
 - a. **Building regional trade links** – in recent years, the UK has invested significant resources into regional trade initiatives in Africa. Regional trade links are crucial to consolidate fragmented African markets and allow international investors to generate economies of scale. China's potential interest in investing in more value-

added economic activity in Africa could offer opportunities for collaboration on regional trade.

- b. **Implementing the WTO's trade facilitation agreement** – The recent WTO deal in Bali committed WTO member states to tackle red tape and improve customs measures. China was an important advocate for the WTO deal, and sees free trade as an important driver to growth. With SSA performing particularly poorly on trade facilitation measures, and with China set to broaden its commercial links with Africa, this could provide an area of collaboration for the UK and China.
- c. **Improved governance in the extractives sector** –China's energy interests in East Africa coincide with a strong UK presence (through Tullow Oil). Plans for a UK-Norway energy initiative in East Africa could yield opportunities for specific collaboration with China on building the conditions for sustainable resource extraction in East Africa.
- d. **Collaboration in infrastructure** - Growing perceptions of the need for more sustainable and considered Chinese investments in Africa – and particularly in infrastructure investment – create opportunities for UK companies. China will still have the financial muscle to fund infrastructure in years to come. But it lacks the reputation and arguably the know-how of world-class UK engineering firms. Building relationships between China's sources of finance (such as China's Export-Import bank), UK engineering firms and Chinese construction firms could result in a powerful partnership.

Vicente Solera-Deuchar and Theo Wellavize
Economics Unit
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