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Future Prospects and Policy Options

As the previous sections have indicated, the growth of China and India has affected SSA through various linkages including trade, foreign direct investment (FDI), aid and debt relief, and migration of Chinese and Indian workers. The impacts are both complementary and competitive, and direct and indirect. The growth of these two countries stimulated demand for raw materials, oil and other intermediate inputs for their domestic markets and export-oriented industries. Because of their relative economic mass, that demand has translated into a general global rise in input prices of the affected commodities. Trade is therefore the principal channel through which the growth of China and India has had an impact on the global economy in general and SSA in particular. Trade opportunities have also influenced Chinese FDI in SSA to secure supplies of resource inputs.

The report has shown that there are two broad categories of SSA countries: mineral resource-rich exporters, which have a clear opportunity to benefit from a dynamic economic partnership with emerging economies; and other SSA countries, which have fewer export opportunities and face challenges from declining preference margins for their exports and increased competition from imports (especially from China and India). The discussion here will focus on China, as being currently the more important partner for which more data are available. As the SSA countries that export to India, and the products, are similar the same observations apply (we will note possible differences in potential export diversification). It is also true that there is similarity between the most important products imported from China and India, although again we will note differences. Mayer and Fajarnes (2008) are optimistic about the potential for SSA primary exports to benefit from a further rise in Chinese demand and the subsequent growth in Indian demand. However, while no more than 10 SSA countries account for almost all exports to China and India, the importance of Chinese and Indian imports is dispersed across most SSA countries. Nigeria and South Africa account for about half (and are also major exporters), but there are significant imports in many other countries – notably Ethiopia, Ghana, Kenya, Madagascar, Mauritius, Sudan and Uganda (of these only Sudan is a major exporter to China). Thus there is a significant differential impact on SSA countries, largely depending on what they produce and export.

Another important distinction is between LDCs and non-LDCs. As noted earlier, the same eight SSA countries are the major exporters to China and India: five of these are LDCs (Guillaumont, 2009: 6–7) – Angola, Democratic Republic of the Congo, Equatorial Guinea, Sudan and Zambia – while Nigeria and South Africa are non-LDCs; Congo is not classed as an LDC.[1] Thus, the 28 other SSA LDCs are not (sufficient) mineral exporters to benefit significantly from demand from China and India. Many of them are exporters of

soft (agriculture) commodities so there is potential to avail of the preferential (tariff-free) access granted by China and India; in this they have an advantage over SSA non-LDCs, such as Ghana and Kenya, that export similar products but without the same preferences (except in access to the EU and to the US under the African Growth Opportunity Act, AGOA). This is potentially important: as LDCs have received the largest trade preferences they are the most vulnerable to preference erosion; only three SSA non-LDCs face significant preference erosion – Côte d'Ivoire (for bananas), Mauritius (for sugar) and Seychelles (for fish) (Milner *et al.*, 2010: 38). While in respect of exports, China and India offer more opportunities to LDCs than to non-LDCs, in respect of imports there is little distinction. Although non-LDCs are more likely to have import-competing producers and to import more, many LDCs also import significant amounts from China and India.

The strategy for responding to China and India should recognise the context of recent SSA experience with trade and trade reform. In the past two decades, most SSA countries liberalised their trade regime, many greatly reducing restrictions on imports; evidence for this can be found in lower average tariffs and, perhaps more significantly, in increases in imports as a share of GDP. Multilateral (WTO) and regional (especially with the EU) agreements have committed them to these reforms. To date, there is little aggregate evidence that these trade policy reforms have produced a significant export response (Morrissey, 2005); exports have not increased consistently, and there is no evident correlation between the extent of trade liberalisation and the rate at which exports have grown (increases in global commodity prices remain the major determinant of increases in export revenue for SSA countries). Export diversification requires additional policies to provide incentives to induce a shift into new export commodities (the common problem here is in identifying 'new' commodities that may in future be internationally competitive) or expand the capacity to produce traditional exports (constrained by limited supply response). However, export diversification has been very limited with the exception of a few countries (e.g., horticulture in Kenya) and 'new' exports have often simply reflected discoveries of minerals (e.g., gold in United Republic of Tanzania). On the other hand, cheaper imports have increased the competition faced by domestic import-competing producers, although consumers (including producers importing capital goods and intermediate inputs) have benefited.

The structure of SSA exports is a particular problem. SSA countries' relative endowments of land and natural resources result in export dependency on primary commodities, and few countries are significant exporters of manufactures (Mauritius and South Africa being the major exceptions). While demand from China and India has been helpful in increasing earnings for mineral exporters, it has done little so far to support other commodity exports or to promote diversification. Dependence on primary commodities subjects exports to the vagaries of a volatile world market; exports also tend to be relatively bulky with high volume-to-price ratios. Many SSA countries are landlocked and many of those that are not have large interiors. Transporting the primary commodities they produce tends to be expensive since these have to be transported large distances overland to reach ports, road and rail systems are often inefficient and sea shipping costs are relatively high (Milner *et al.*, 2000). In such a situation, trade confers limited benefits – the capacity of the export sector to respond is impeded, whereas domestic producers will face increased competition from imports.

In countries dependent on agricultural exports, farmers face many constraints in gaining access to factors, inputs and technology, which restricts their ability to increase production in response to improved (export) price incentives (Morrissey, 2005). Consequently, one rarely observes a quick export response to higher prices or new market opportunities. Domestic policies are necessary to reduce the varied constraints on supply response, increase transport and marketing efficiency and encourage investment in transport, distribution, business services and trade facilitation. SSA countries need to increase the flexibility and efficiency of resource use so that they can be competitive in global markets. The inflexibility of factor markets, a serious problem in Africa, is a major impediment to gaining from trade as it limits the ability to reallocate resources. The ability of SSA countries to expand exports of manufactures is severely restricted by the small size and low levels of efficiency and of investment in technology of local manufacturing firms.

Whilst it is useful to consider exports to and imports from China and India separately it must be acknowledged that both countries can affect the pattern of SSA trade, within SSA as well as export shares in world products, and the types of products traded. Kaplinsky and Morris (2008, especially Table 9) consider the technology-intensity of SSA trade. As previously noted, SSA exports to China are mostly primary commodities (oil and gas, accounting for 81 per cent) or resource-based (15 per cent), while the pattern of exports to India is reversed with resource-based products (46 per cent) a greater share than primary commodities (38 per cent). These two categories also account for over 80 per cent of SSA exports to the rest of the world. Thus, extra-regional exports are largely unprocessed, i.e., can be considered as having no technology-intensity (although extraction is capital intensive, there is no manufacturing technology). The main implication is that few SSA exports generate significant value-added or promote production linkages and technology spillovers with the rest of the economy.

Addressing this (long-standing) problem requires SSA countries to move into processing activities, i.e., some of the manufacturing that adds value to the primary resources they have. This would be in medium technology manufactures, in which there is some activity (low technology goods tend be labour intensive and SSA is not competitive given high labour costs, especially relative to Asia). Although resource-based products account for 35 per cent of intra-SSA exports, medium technology products, which have the highest share in intra-SSA markets compared to other markets, account for 23 per cent (Kaplinsky and Morris, 2008, Table 9). Generally, the relatively technology-intensive SSA exports can compete with similar products within SSA (enjoying preferential market access and advantages of proximity) even if SSA manufactures are not competitive against similar products from more efficient global producers on the global markets. Regional trade, and by implication regional integration, offers the best opportunity to promote manufactures exports in SSA.

Growth in exports of low-cost manufactures by China and India has been accompanied by substantial declines in world manufacturing prices (Kaplinsky *et al.*, 2006). This poses a serious threat of China and India crowding out SSA's small range of manufactures exports in third-country markets and also out-competing SSA manufacturers in their domestic markets. As discussed in Section 2, the clothing sector may be the best example of this (see also below). While SSA countries should not neglect opportunities to develop garment

exports, these may not be a secure platform for long-term export growth. Thus, the basic message in terms of a development-oriented long-term SSA export strategy is to concentrate on adding value (processing) to the resources they have.

Opportunities for SSA

As they are predominantly exporters of primary commodities, one of the most important stylised facts for SSA is the trend decline in commodity prices throughout most of the last century for the goods they export; only recently has a reversal been evident, mostly for minerals. Between 1990 and 2000 world prices for cocoa, cotton, sugar and copper declined by over 25 per cent, coffee by 9 per cent and minerals overall by 14 per cent (WTO, 2001: 212). Producers responded to this; in particular, farmers tended to diversify away from traditional (cash crop) exports towards food crops for the domestic market. However, given various problems afflicting agriculture, food production rarely kept pace with population growth. Commodity prices surged during 2001–2008, fuelled by demand from China: for Africa as a whole, export unit prices fell by 2 per cent per annum between 1995 and 2001, but increased at a rate of 17 per cent per annum between 2002 and 2006 (UNCTAD, 2008).

For those countries that are already exporting raw materials to China and India, and for others that discover or develop extractive resources in the future, the issue is ensuring that the sector benefits the whole economy and generates investment to support diversification. For SSA countries that lack mineral resources, the issue is accessing markets in China and India for what they can export. For example, there is potential for food exports in the longer term (as China and India account for some 40 per cent of world population). The two types of country are considered separately, but an export diversification strategy is considered in a common framework covering three inter-linked issues: (1) ensuring domestic revenue from export earnings; (2) ensuring a development impact from investment projects; and (3) promoting local linkages.

Exports of mineral resource-rich countries

As observed above, the major commodities exported by SSA to China and India are mineral fuels, ores, stones and metals in value terms. The mineral resource-rich SSA countries that export these products should focus on how to benefit most from the opportunity presented by a dynamic economic partnership. As China and India are likely to sustain their growth for a considerable period, even if at lower rates, the markets are reasonably secure and steady demand for a volume of exports can be anticipated. The concern for the SSA countries essentially relates to the price, or more generally the share of the export value retained in the exporting economy. There is no reason to believe that this share is high or even reasonable as typically foreign firms are involved in extraction and export (in this respect, Chinese firms are no different to Western multinationals), and the price or rent received by the country is negotiated between the firm and host government (and costly corruption cannot be discounted).

A number of principles can be advanced to guide negotiating, or renegotiating, the revenue received (typically a payment from the multinational to the government). First, even if a forward price is specified the world price should be a reference. A suitable aim is that the government receives a proportion of the world price such that the value of this proportion is greater than a minimum price per unit exported. Export revenue rises in line with prices, but should the world price fall the government is guaranteed the threshold price. Second, the government should designate a fund in which the revenue is placed and indicate how the revenue will be spent or invested (where the revenue involved is very large, a Sovereign Wealth Fund is appropriate). Transparency is desirable so the allocation of revenue, in particular any contribution to government expenditure, can be monitored. Third, in the case of large projects, the investor should provide some investment in development (e.g., hospitals, schools or sanitation for affected local communities); this could be considered as an offset against any investment incentives (such as tax breaks) but not against the price. Finally, the investor should commit to employ local labour insofar as possible, at least for less skilled work, and where local input or service suppliers exist they should have the opportunity to tender in an open process. This final set of principles can be applied to any large investment (or aid) project as a means of promoting local linkages to benefit the economy.

Exports of soft commodities

It is evident that SSA countries are increasing exports to China and India for a variety of soft (agricultural) commodities, such as cotton, coffee, cocoa, tobacco; fruits, nuts and vegetables; and oils and resins. Some SSA countries may be able to export seafood, and others have potential in hides, timber and wood pulp. Countries that have production capacity in these products should be given some assistance in identifying the potential for exports to China and India. Note that these are typically products in which SSA countries already have (potential) comparative advantage so they are sectors suitable for policy support anyway. Although investment is needed to increase productivity, and foreign investment may be suitable if it provides integration with global supply chains and access to technology, these are sectors particularly suited for domestic investment.

A particular problem facing SSA exporters of soft commodities is that the dynamics of global demand and prices are more complicated than for minerals. 'Agricultural commodities seem to have other drivers [compared to minerals ... D]emand from China, India or other emerging markets [has not been] an over-riding factor in determining price trends in this sector ... What is certain is that the huge populations of Brazil, China and India will mean these countries continue to play a critical role in world food markets as both major producers and consumers' (OECD, 2010: 51). This issue is most evident for food grains (and many SSA countries are net importers), where price volatility is caused by production shocks, such as associated with the recent fires in Russia and floods in Pakistan. Nevertheless, China and India represent new market opportunities.

Export diversification

History shows that resource-dependent exports have not generally supported African growth and development. Insofar as China and India (and other emerging markets) are merely displacing industrialised countries as export destinations, so that the commodity composition of trade is unaltered, the danger is that SSA countries are experiencing another commodity boom that will fizzle out, as previous booms have, without a lasting impact on development. To avoid the problems of the past and establish a platform for future growth, it is important to ensure that revenue from export earnings is invested in projects that promote linkages with the rest of the economy and support export diversification. A general strategy is to identify possibilities for value-added processing and the associated investment requirements, recognising that simply having the raw resource is not sufficient to justify establishing a processing sector. For example, processing of ores is typically energy-intensive, so it is only feasible to develop a processing sector if there is an adequate supply of electricity. Processing also requires a scale of activity to be efficient and competitive.

Given their access to trade preferences, LDCs have more opportunities than non-LDCs. The Duty Free Tariff Preference Scheme announced at the 2008 India–Africa Forum Summit provides opportunities for SSA LDCs to increase exports of minerals (aluminium and copper ores), soft commodities (such as cotton and cocoa), some foodstuffs (e.g., cashew nuts, cane sugar and fish) and even ready-made garments. Similar opportunities exist for China where LDCs also get tariff-free access for most products. The challenge for SSA LDCs is to produce the value-added products to benefit from these schemes.

Competition from China and India may also affect SSA exports to third countries. Quite detailed investigation and disaggregated data are required to determine where this may be the case. For example, although SSA may appear to compete in garments, it is rarely in head-to-head competition because countries can avail of trade preferences (and indeed China and India invest in SSA for this reason). It may also be that they produce different garments. To give another example, both Botswana and India export diamonds; however, closer investigation shows that Botswana exports raw diamonds while India exports cut diamonds. In this case Botswana and India are not competitors. It may be that India imports raw diamonds from Botswana to process and export as cut diamonds. The question for Botswana is whether it should engage in this processing. On the basis of highly disaggregated trade data, Kaplinsky and Santos Paulino (2006) find that increasing Chinese exports to the EU will tend to reduce prices, which will have an adverse impact on other low-income suppliers. However, these are more likely to be other countries in Asia rather than countries in SSA. Furthermore, as SSA producers (irrespective of whether or not they are LDCs) have preferential access to their main markets, the EU and USA, they are somewhat protected from competing with China and India.

In responding to trade relations with China and India, SSA needs to derive more benefit (especially revenue) from existing exports (mineral resources) and identify and diversify into new export opportunities. The former essentially relates to the terms on which access to resources is negotiated and export revenues are shared, typically done in conjunction with foreign investors, and the latter requires an investment strategy.

Indeed, any policies aimed at benefiting from trade opportunities should be linked to an economy-wide investment strategy.

Utilising official flows (FDI and aid)

Foreign investment in SSA has been driven largely by one of two motives (as most domestic markets are small, market serving is rarely a prime motive): access to resources (extractive industries), traditionally by multinationals aiming to serve world markets but recently by China ensuring supply to its own market; and export opportunities, in particular where SSA has preferential access to large markets (such as to the EU or USA, see Milner *et al.*, 2010). China (and probably India, although there is less information) has engaged in both types of investment in SSA. As relations with China and India develop, more investment is likely. As already mentioned, care is required to ensure that investment in extractive sectors generates real benefits for the local economy, and similar considerations apply for 'export-seeking' investment. SSA countries should be receptive to foreign investment that is offered, but they should ensure they get a full share of the benefits.

A particular problem with 'export-seeking' investment arises when it is attracted by temporary opportunities such as trade preferences. The experience of Chinese investment in the clothing sector shows how the benefits can be limited and transient. Prior to the late 1990s, Chinese clothing and textile firms were located in SSA to circumvent the Multi-Fibre Agreement (MFA), which placed quotas on Chinese (and other countries') exports of textiles and clothing (in particular to the USA). Since 2000, China has invested in clothing production in SSA to exploit the preferential market access to the USA under AGOA. Given these opportunities, the clothing and textiles sector in SSA expanded rapidly and became significant in some countries, e.g., garments were 99 per cent of Lesotho's total exports, 98 per cent of exports to the USA and 50 per cent of GDP in 2004 (Kaplinsky *et al.*, 2006, Table 2.5). Chinese FDI in clothing and textiles in Kenya's export processing zone (EPZ) saw the EPZ account for nearly 20 per cent of formal wage employment in 2003 (Kaplinsky *et al.*, 2006). However, Chinese firms imported intermediate inputs from China and engaged in limited investment in production facilities. The only significant case of the development of a clothing industry was the construction of a US$100 million denim plant in Lesotho, which started operations in mid-2004 (Kaplinsky *et al.*, 2006: 11). Although Chinese investment afforded host SSA countries an opportunity to participate in global value chains, few linkages (to local suppliers) were established to spread the benefits throughout the host economy.

The expiry of the MFA in January 2005 had the dramatic effect of increasing the relative significance of high costs of production in SSA, which had previously been outweighed by the advantages from circumventing the Agreement, so locations in Asia became more competitive. Chinese FDI started pulling out of some SSA countries, leading to declines in their garment exports and employment; the overnight gains of participating in global value chains disappeared with the deserting Chinese firms (Kaplinsky and Morris, 2008; 2009). The most affected countries were South Africa (where export value fell by 45 per cent), Lesotho (17 per cent) and Swaziland (10 per cent). Employment in the sector fell by

56.2 per cent in Swaziland, 28.9 per cent in Lesotho, 12.2 per cent in South Africa and 9.3 per cent in Kenya. Relations with China and India provide opportunities to attract investment, but no guarantees that the investment will contribute to increasing local productivity and development.

This serves to highlight the fact that SSA governments should remain aware that FDI can be transient in nature, which is most likely if the investment is motivated by accessing trade preferences that may themselves be temporary. Investment motivated by securing access to resources is more long term, but governments must ensure they receive the right price.

As discussed earlier, aid from China and India is largely indistinguishable from investment so it could usefully be treated as a complement to FDI that can be directed at development needs. China and India do attach conditions to their aid, typically related to 'access to natural resources or the purchase of goods and services provided by firms in the country providing support' (UNCTAD, 2010: 62). In this sense Chinese aid is quite similar to much of the FDI: the recipient gets something (the project is completed) but little extra. This restricts the benefits because it limits the potential linkages – an issue that recipients should address. On the other hand, the projects are concentrated in infrastructure and production and often involve participation of private firms so there is potential to promote local private sector involvement. 'There are a number of potential benefits from Chinese aid: better targeting on important infrastructure projects with long maturity and long-term potential; less bureaucracy (meaning lower transaction costs); greater efficiency and potentially faster response' (OECD, 2010: 89). The policy issue is integrating aid and investment from China and India into a coherent development strategy that includes diversifying production and exports and reflects the regional SSA needs.

Challenges facing SSA

Chinese and Indian imports represent challenges to SSA producers in domestic markets and in third-country export markets where SSA competes with China and India. The latter has been considered above (and in general is unlikely to be a major concern, except perhaps to countries like South Africa) so here we focus on import competition. The products where China and India have the largest import shares are not generally sectors in which SSA countries have significant production capacity, so domestic producers are not severely affected. In these cases issues may arise as the treatment of other sources of imports, notably the EU, alters and we consider this in the context of Economic Partnership Agreements (EPAs).

However, there is some evidence that competition from imports has displaced domestic producers in certain sectors and countries: 'it has been reported in many African countries that the influx of cheap manufactured products, mostly from China, presents challenges for local manufacturing firms ... [and some] traditional products that had been manufactured in Africa for several centuries are now being almost exclusively produced in China' (UNCTAD, 2010: 41). Kaplinsky *et al.* (2006) report anecdotal evidence from firms of Chinese imports displacing domestic clothing and furniture manufactures in Ghana and South Africa and clothing and footwear in Nigeria and Zambia. In Ethiopia, Asian imports

undercut domestic shoe manufacturers so that a little under a third closed, almost a third contracted activity and the average firm size halved (Egziabher, 2006). The evidence that exists relates mostly to clothing, footwear and furniture; as found above (Table 2.6) these are among the products with the highest import share for China in some countries so the potential problem is real. Garments are worth considering as they encompass both import competition in domestic markets and threats to third-country markets as well as involving foreign investment.

The clothing sector

Competition from China and India in domestic and regional markets can limit the potential for SSA countries to develop a viable garment export sector. It is important to distinguish three main stages in the production chain: (1) raw materials, such as cotton and wool (which some SSA countries export); (2) textiles made from the raw materials (which is concentrated in China and India, with few SSA countries producing textiles); and (3) garments made from the textiles. The SSA countries in which the sector is important tend to import textiles to produce and export garments. They compete with (lower cost) producers, including China and India, in garment exports but benefit from preferential access, to the EU and USA in particular. One apparent advantage is that China and India see a benefit in providing textile inputs to SSA garment producers that can then avail of preferential access to the EU and North American garment markets (van Dijk, 2009).

Historically the clothing and textile sector has been an important entry point for industrialisation in low-income economies because of the relatively low technology intensity required. The global market for clothing is large and dynamic, characterised by short lead-times, inter-seasonal and intra-seasonal variety and tight logistics (Gereffi and Memedovic, 2003). The global clothing trade is a standard example of a value chain, involving global buyers with market power (such as retailers in the major consuming markets), global intermediary sourcing firms and disparate producers (Gereffi, 1999; Gibbon, 2003) with large volumes of clothing produced and sourced from the lowest priced suppliers. Trade preferences gave SSA producers an attractive position despite (labour) cost disadvantages, which attracted FDI and promoted exports, but few managed to move up the global value chain (Mauritius has been successful in producing high-value niche products). As discussed above, the evidence that FDI in clothing is footloose suggests that SSA producers do not have a secure place in the supply chain.

The largest SSA beneficiaries of garment sector FDI (from China and elsewhere) are exporters of clothing (especially to the USA) such as Kenya, Lesotho, Madagascar, Mauritius, South Africa and Swaziland. However, growth in China's and India's exports has been accompanied by a substantial decline in world manufacturing prices (Kaplinsky *et al.*, 2006). This poses a serious threat of crowding out the small range of SSA exports in third-country markets. Meanwhile, partly as a result of falling unit prices, China's exports flourished – for example, increasing by 58 per cent in the USA (Kaplinsky *et al.*, 2006). It is evident that the growth of China's exports had a direct adverse impact on exports from some SSA countries. The massive fall in employment across affected sectors in SSA represented a major setback

for poverty reduction in respect of the scale of job losses and impact on female employees (Kaplinsky *et al.*, 2006). The benefits of reduced prices of imported Chinese clothing do not offset the large negative impacts, and to the extent that they displace local producers in domestic markets they exacerbate the situation.

Relevance of EU–SSA trade relations

Almost all SSA countries are party, in one way or another, to EPAs with the EU (Morrissey, 2010), a core feature of which is the elimination of tariffs on most imports from the EU. For the average SSA country, EPAs are likely to increase imports from the EU by 6–8 per cent and total imports by about 2 per cent (Morrissey and Zgovu, 2010: 74). Thus, although much of the consumer gain (from lower prices as tariffs on imports from the EU are eliminated) arises from increased imports of goods already previously imported from the EU, the EU will take market share from other countries. Whether this displaces China or India will differ across countries according to their pattern of trade in products in which the EU is competitive. Morrissey and Zgovu (2010: 69) identify Madagascar, Sudan, Uganda and United Republic of Tanzania as countries that have relatively high import shares from the rest of the world (imports from China and India are significant in all four, see Table 2.5 above) that may be displaced by tariff-free imports from the EU.

The EU is likely to displace some imports in the three most important sectors for imports from China and India (electrical and mechanical machinery and vehicles) and also in articles of iron or steel (important for China) and pharmaceuticals and cereals (important for India). The extent to which this may happen can only be identified at a country level. For example, Milner *et al.* (2010a: 88) note that the likely effect of an EPA for Mauritius is to increase imports from the EU particularly in the textiles, machinery and consumer electronics sectors. As China and India are suppliers of significant imports to Mauritius in these sectors, they are likely to lose market share as tariffs on EU goods are eliminated.

It is probable that the effects of EPAs on import shares of China and India in SSA countries will elicit a response. For example, as China and India offer preferential access to LDCs they may seek reciprocal preferences. An alternative scenario (which may already be happening) is that imports from China (and India) are tied to aid or investment projects, hence exempted from tariffs and resilient to EPA effects. If SSA countries succumb to these pressures they must be aware of the associated tariff revenue loss.

It should be noted that EPAs may offer a benefit in terms of making SSA more attractive to FDI to access the EU market. Chinese and Indian FDI has already responded to opportunities to avail of trade preferences (e.g., AGOA). As access is constrained by rules of origin requirements, such 'preference-seeking' FDI must deliver relatively high levels of domestic value added, hence promoting linkages and diversification (see also Milner *et al.*, 2010: 42–44). Investment is a major determinant of economic growth, but SSA countries tend to have relatively low levels of investment, and the productivity of investment tends to be low; this is one of the reasons why their growth performance has been less than desired. Increasing the level and productivity of investment is essential to delivering increased and sustained growth. Foreign investors deliver particular benefits in expanding the level of investment,

in transferring technology, management and human capital, and potentially in linking with domestic firms (through joint ventures or supply chains). In general, while investment measures may aim to target particular sectors, they need not discriminate between domestic and foreign sources. In other words, even where the aim is to attract foreign investment any incentives offered can and should be available to domestic investors.

Policy responses to China and India

A number of policy issues should be addressed to allow SSA countries to benefit from expanded economic relationships with China and India. Building on the preceding discussion these are outlined here and summarised as recommendations in the final section. The suggestions are not inherently new. UNCTAD (2010: 102–105) provides a set of broad-based recommendations for African countries engaging with South–South co-operation. The responses we identify are similar, but more specific to trade and investment (including aid) with China and India. The recommendations regarding export diversification are similar to issues that have often been raised as to how SSA can respond to the changing global trade environment, e.g., Milner *et al.* (2010: 46–50) in the context of the erosion of trade preferences. The central issue is deriving widespread gains from export opportunities while recognising the adjustment needs of increased import competition. A specific concern is that China and India are competitive suppliers of labour-intensive products, i.e., in some of the sectors in which SSA countries are trying to develop production capacity. However, to the extent that China (and India) invest in SSA countries to promote manufacturing for export and to link with domestic suppliers, they can stimulate higher quality production and offer opportunities for SSA producers to position themselves better in global value chains (Knorringa, 2009). The problem, as discussed throughout this report, is that to date there is little evidence to indicate this is actually happening.

At the core of the response of SSA countries to their relationship with China and India is the need to target investments and co-operation to diversify production and exports. As noted above, it is important that SSA 'does not replicate the current pattern of economic relations with the rest of the world, in which Africa exports commodities and imports manufactures. In this regard, it would be desirable if African countries and their developing country partners manage their growing and evolving relationships in a manner that supports and enhances technological progress, capital accumulation and structural transformation in the region' (UNCTAD, 2010: 4). The language of Chinese and Indian economic co-operation is consistent with these objectives, but it is up to each SSA country to devise the appropriate diversification strategy, which is most likely to be effective if grounded in existing capabilities in value-added processing. Individual countries need to identify what resources they possess for which it is economically feasible to add value by establishing processing industries that can become competitive. The objective has been clearly stated elsewhere:

> [T]he focus should not be on attracting Southern FDI per se, rather it should be on how to create linkages between FDI and the domestic economy and also how to direct it to sectors where it can boost productive capacity, catalyse domestic investment, create

> employment, spur regional integration and enhance integration into the global economy. The use of targeted incentives to encourage foreign investors to source inputs locally is one way to promote linkages between Southern FDI and the domestic economy. The promotion of joint ventures between African and Southern firms could also facilitate the diffusion of knowledge to local entrepreneurs and contribute to structural transformation. Another means through which developing countries could promote investment and boost industrialization in Africa is through the creation of special economic zones (SEZs). These zones have played an important part in China's economic development and have also been used by Mauritius as a source of surplus to develop the rest of the economy. It is interesting that China has recently taken the lead in establishing SEZs in the region. (UNCTAD, 2010: 96)

In respect to existing exports (mineral resources) the principal issue is the terms on which access to resources are negotiated and export revenues are shared to derive more benefit, especially promoting linkages with local firms (as goods or services providers), generating local employment and providing revenue to invest in development. A cornerstone of any mineral resource strategy is how SSA governments engage with the foreign investors, whether countries or firms, seeking to access and export their mineral resources. This is a bargaining issue where too often SSA governments have not secured the best deal for their country. Typically, the foreign investors want the unprocessed resource at the lowest price whereas clearly the SSA country benefits most where it gets the highest price, especially if it can undertake some of the processing.

Diversifying production to benefit from trade opportunities (identifying new markets) and expanding non-mineral exports requires an economy-wide investment strategy to relax supply constraints. The investments can be sector-specific, either to support new value-added industries processing resources or relaxing constraints in existing export sectors (LDCs could focus on those products they can export to China and India under preferences). Investment is also needed in infrastructure at a country and regional level; in areas such as transport and power generation regional projects are as important as national ones. A strategy to use aid and investment must have promoting linkages and private sector development at the core. As the projects supported by China and India are concentrated in infrastructure and production (including agriculture), are often long-term in orientation and frequently involve participation of firms (private or state-owned), there is potential to integrate financial inflows with a development strategy based on diversifying production and exports.

A related issue is addressing the nature of relationships between individual (small) SSA countries and large partner countries, where for Europe and the USA now read China and India. The large countries have a consistent strategy with each individual partner, but the individual countries have no clear strategy for engagement. Furthermore, individual countries are weaker when operating alone. 'Africa has not articulated a coherent regional approach to harnessing and managing these partnerships for its benefit ... [Chinese and Indian] actual engagement as well as implementation of projects is at the country level with often no link between these projects and the regional priorities of Africa' (UNCTAD, 2010: 26). A more regional approach can also be relevant to investment. 'However, so far the emphasis has been on national rather than regional infrastructure. African countries should encourage Southern partners to extend the scope of their infrastructure finance to the

regional level as an important channel to reduce transactions costs, link national markets and boost intra-African trade and investment' (ibid.: 77).

Greater co-ordination for a regional SSA approach to China and India is desirable and it is becoming more feasible. One effect of EPAs is to promote regional groupings to negotiate with the EU, even if this has not worked well in all parts of SSA. The same groups could begin to engage with other countries. African countries have shown that they can work together in trade negotiations in the WTO.

> Africa's cooperation with developing countries in multilateral trade negotiations has had a significant impact in three key areas. First, it has enabled developing countries to influence the agenda and pace of the Doha Round negotiations ... By forming alliances, developing countries have now been able to influence developed countries to abandon three of the Singapore issues – investment, competition policy and government procurement. Second, the formation of alliances between Africa and other developing countries has increased their level of participation in the negotiation process [and increased the] bargaining power of African countries. Third, as a result of increased cooperation with Africa, several developing countries have put in place schemes to provide preferential market access for products originating from LDCs, most of which are in Africa. Brazil, China and India are examples of developing country partners that have put in place such schemes. (UNCTAD, 2010: 46)

As SSA countries develop co-operation with China and India it is important that they remain aware of the broader context of globally declining trade preference margins and the associated need for export diversification. Measures that make SSA more attractive to foreign investment and incorporate FDI in domestic development strategies can support this (Morrissey, 2010a: 231):

- Reform of regulatory and administrative procedures that reduce the costs of doing business (e.g., reducing the number of forms and licences required to invest or to start a business) encourages investment.
- Investment incentives can be targeted at sectors with potential for export growth, such as agri-processing. This can be especially important for LDCs aiming to avail of preferences granted by China and India.
- Measures that promote regional integration increase the potential market size and facilitate co-operation between SSA countries. This can attract foreign investors, generate scale economies and support a more co-ordinated engagement of SSA with economic partners.

Regional integration measures associated with EPAs provide an opportunity for SSA countries to attract higher levels of more diversified FDI: larger markets, lower transactions costs associated with trade and investment, and generally a more favourable business environment are all conducive. Although EPAs are most likely to make SSA more attractive to EU investors, there will be opportunities that are attractive to China and India.

Concluding recommendations

Economic relations with China and India have important effects on SSA countries, directly and indirectly and primarily through trade and investment. Although the initial and

largest benefits accrue to exporters of fuels, minerals and metals, there is future potential for benefits to agriculture exports of oilseeds and vegetable oils, fish and seafood. As per capita incomes rise in China and India one may also anticipate increased demand for fruits and vegetables. Thus, although to date the significant export benefits have been limited to resource-exporting countries, there are future opportunities for other SSA countries. These opportunities will be squandered if viable domestic export producers are not supported.

Although the major products imported from China and India are machinery and equipment, vehicles and pharmaceutical products that do not compete with local industries (except perhaps in South Africa), an increasing import share has been captured by Chinese consumer goods (electronics, clothing, shoes), and Indian goods may follow. From an import perspective, the issue is whether competition from cheap imports is preventing the growth of domestic producers. SSA countries may have to increase their efforts to support domestic production and employment, but this should be by focusing on sectors that use available resources. Value-added processing offers the most viable manufacturing opportunities, especially in agri-business. The traditional policy of tariff protection is not viable in the context of progressive reductions of tariffs. Tariffs against imports from the EU will be reduced as EPAs are implemented, and China and India may seek some reciprocity for the duty-free access it grants to the least developed African countries.

A number of policy recommendations follow from the discussion and, as the details are country-specific, they are summarised in general terms. SSA countries should:

Increase their share of export revenues. Mineral exporters should ensure that they receive a competitive market price or share of the resource rent so that appropriate revenue is generated for the country. The revenue from exports should be invested in promoting development; this may be achieved most effectively through a designated, transparent fund.

Target new markets. Producers of non-mineral (soft) commodities should be supported in identifying opportunities to export to China and India through the provision of market information and access to networks. This is especially relevant for LDCs, which are granted preferential access to China and India for most commodities, and has potential for a wide variety of agricultural commodities.

Base effective export diversification on identifying value-added activities to process available resources. Individual countries should identify the resources they possess and where there are feasible opportunities (e.g., adequate supply to reach an efficient scale of production, access to inputs such as energy) to establish processing industries.

Understand that tariff protection is not a good policy response. Imports from China and India can compete with some domestic producers, but governments should only support (by measures to increase productivity) local firms that can become competitive.

Develop a co-ordinated investment strategy. SSA governments should ensure that aid and investment projects by China and India contribute to the local economy and development. This requires that projects link to sectors governments want to develop or provide national and regional infrastructure to increase productive efficiency and reduce trade costs. Investment by China and India is (legitimately) motivated by their own commercial interests and cannot be assumed to assist the integration of SSA producers into global value chains. The experience with garments cautions that such investment can be transitory.

Co-operate with each other. More effective engagement with China and India is possible if SSA countries co-operate. A co-ordinated or at least consistent approach to terms of access to mineral resources would increase the bargaining power of SSA countries and allow a greater share of the revenue to remain in the source economy. Co-operation has strengthened Africa's position in trade negotiations, such as in the WTO, and would also encourage regional investment projects.

Develop policies that recognise the broader trade environment. Relations with China and India will be affected by trade agreements with other parties, notably EPAs with the EU but also future developments in the WTO. Whilst EPAs may allow the EU to capture some market share from China and India in SSA imports, as they enhance preferential access to the EU, they will also make SSA more attractive for investment.

These policy recommendations are not inherently specific to relations with China and India. African countries should strive to avoid the 'resource curse' by negotiating access to resources more transparently with all countries or multinationals, and should strive to use aid and investment from all sources more effectively. New economic partners provide new opportunities, but the underlying issues are unchanged and SSA should avoid the errors of the past. SSA countries should not look to China and India to provide support for the development of domestic production, although they should not neglect opportunities that arise. Foreign investment delivers the greatest benefits when it provides linkages to the local economy, such as through employment or demand for local supplies. Chinese investment has not evidently delivered these benefits, and this is an issue that governments should monitor.

Ultimately, African development is its own responsibility. This means that SSA governments should ensure that they receive and use strategically the revenue from export earnings, which is the major benefit of trade with China and India, and should strive to realise all opportunities to diversify production and exports.

Notes

1. It is not obvious why this is the case as the Congo is a small, low-income state not obviously distinct from Democratic Republic of the Congo, or other LDCs, in terms of income or fragility (Guillaumont, 2009: 15).