

IB ECONOMICS – INTERNAL ASSESSMENT

FRONT COVER

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China-Peru Trade Agreement Expands China's Reach in Latin America

By Jason Simpkins

China and Peru signed a free trade agreement Wednesday that will pave the way for further cooperation between the two countries and broaden China's influence in Latin America.

Chinese President Hu Jintao landed in Peru along with a delegation of nearly 600 business leaders and finance ministers that will accompany him to this weekend's Asia-Pacific Economic Cooperation (APEC) summit in Lima. However, before the conference officially kicks off, President Hu and Peruvian President Alan Garcia signed a free trade agreement that will likely result in China overtaking the United States as Peru's biggest trading partner.

The mineral-rich Peru, which is home to large deposits of iron ore and copper, figures to play a large part in China's relentless quest for raw materials. Aluminum Corp. of China Ltd. (ADR: ACH), for instance, recently signed a \$2.2 billion deal to extract more than 7 million tons of copper from Peru's Toromochu mine.

"Some foreign companies are basically canceling their projects in Peru," Zhu Jingyang, a Chinese representative in Lima told The Associated Press. "That's not the case for China."

China has made similar forays into other Latin American countries, such as Chile, where it signed a free trade agreement in 2005. Last year, China supplanted the United States as Chile's top trading partner. Analysts see a similar situation unfolding in Peru.

"It is inevitable that China will become Peru's number one trading partner," Juan F. Raffo, chair of APEC Business Advisory Council, told the Financial Times. "China now has 300 million people that are comparable to U.S. citizens in their consumption . . . that figure is growing. Their 1.3 billion citizens, minus the elderly, are sooner or later going to jump the fence and consume at developed world levels."

Luis Valdivieso, Peru's finance minister, told the FT that China would be instrumental in helping Peru outgrow its dependence on the United States.

"We are very concerned about the recession that is going on in the U.S., Europe and the slowdown in Japan," Valdivieso said. "So for us, China becomes an important partner."

Valdivieso added that the United States will remain an important trade partner, but that it is also crucial that the country diversify its markets. That is true of almost all Latin American countries where trade with China is growing at a torrent pace. China's trade with Latin America totalled \$102 billion last year, but it has already eclipsed \$111 billion in the first nine months of 2008.

In addition to Peru and Chile, China has already signed free trade agreements with Costa Rica and Cuba. In fact, Cuba's state news agency reported that President Hu has signed almost a dozen agreements with Cuba, including plans to upgrade infrastructure and buy sugar and nickel.

And last year, China's State Administration of Foreign Exchange (SAFE) last year used the purchase of \$300 million in Costa Rican government bonds as leverage to get the Central American nation to sever diplomatic ties with Taiwan that stretched back 63 years.

In Brazil, China is currently in negotiations are negotiating to build a \$3 billion steel mill with help from the Bank of China, which is set to open a branch with a \$100 million in lending capital there next year. China has also sunk billions into oil exploration in Ecuador, Colombia and Venezuela.

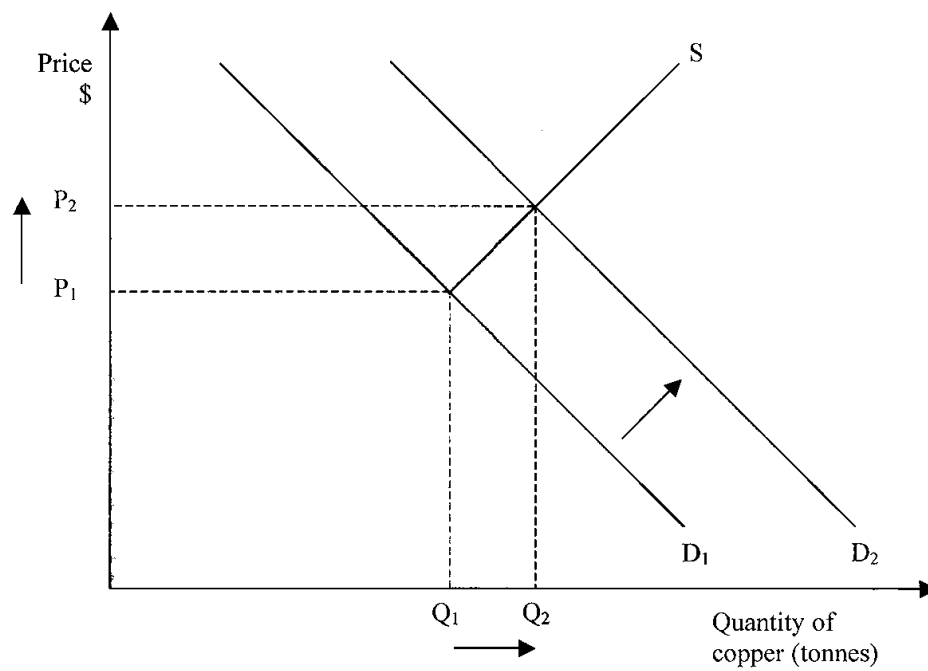
"The reality is that to some degree the fate of Latin America has been decoupled from the US," Daniel Erickson, of the Inter-American Dialogue thinktank, told the AP. "Or at least it's not as tightly entwined as it used to be."

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A free trade agreement means that there will be virtually no trade barriers between members, and that members can trade in whichever way they like with non-members. By forming this agreement with China, it appears that Peru is adopting export-oriented strategies for growth, meaning that they seek to increase their GDP by selling their goods on foreign markets.

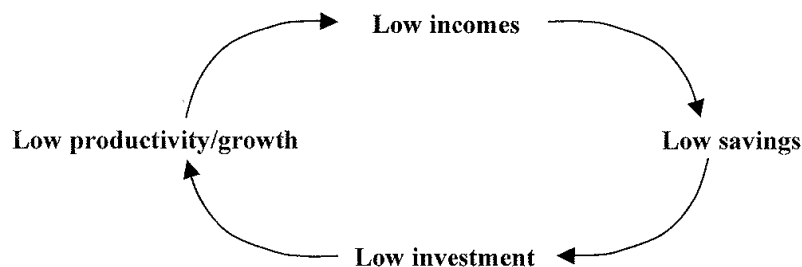
China's growing markets of "300 million people that are comparable to U.S. citizens in consumption" would greatly add to the demand for Peru's copper and iron ($D_1 \rightarrow D_2$).

Effect of liberalizing trade with China on Peruvian copper market



Although demand for commodities such as copper tends to be price inelastic, demand for Peruvian copper in particular is more elastic because there are many alternatives such as copper from another country. The total revenue for Peruvian copper producers should increase ($P_1Q_1 \rightarrow P_2Q_2$). However, increasing output ($Q_1 \rightarrow Q_2$) to meet increased demand requires significant amounts of investment, which is the addition of capital stock to the economy by firms. For this to occur firms need to be able to take loans but, as is characteristic of a less developed country, Peru has low saving rates and therefore not much money is available for loans. Instead, Chinese firms can fill the savings gap by investing directly in Peru such as “Aluminium Corp. of China Ltd” extracting copper from the Toromocho mine. This is known as foreign direct investment.

This investment leads to an increase in Peru’s GDP, which is the total amount of goods and services produced by factors of production residing within Peru’s borders in a given period of time, usually a year. It will also break the poverty cycle that might otherwise prevail in Peru:



It raises investment in Peru as well as creating more jobs for local workers, which will reduce unemployment and raise local incomes.

However, it could be that all profits are sent back to China and thus will not contribute to Peru's growth in the long run because profits are not reinvested into Peruvian industry. To determine the effect of Chinese investment it would be more useful to look at GNP, which is similar to GDP but excludes output produced by foreign factors of production in Peru and includes output by Peruvian factors of production overseas.

Nevertheless, Peruvian firms are likely to gain knowledge and improve technology from this investment as it can learn from Chinese multinational corporations (MNCs). MNCs are firms that have assets in at least two countries. Human capital may be improved because management and entrepreneurial skills can be transferred to local businesses, and because Chinese firms might educate local workers. Improved quality of the factors of production labour, capital and entrepreneurship will increase Peru's potential output and, in the long run, possibly increase actual output. The problem is that MNCs rarely employ locals in high positions.

Furthermore, it is not certain that Chinese investment will lead to development in Peru. Development is considered as a general increase in the standard of living in terms of health, education, etc. and, in a broader sense, greater choice and freedom could be included. On one hand, foreign investors often "upgrade infrastructure" as China has promised to Cuba, which will benefit citizens and local industries. This could include improving the electricity supply or building roads. The government can also gain tax revenue from, for example, the "\$2.2 billion deal to extract copper" and if this is spent on merit goods then it could contribute to development.

On the other hand, intensive mining could lead to pollution and the depletion of natural resources in the long run. This is not sustainable development because it doesn't

allow present populations to meet their needs without compromising the ability of future generations to meet their needs. While investment of this kind can generate short-term growth, it is likely to be unsustainable and leave governments with increased costs in the future.

To sum up, Chinese firms benefit the most from the free trade agreement because they can exploit new natural resources without facing consequences. Peruvian workers may benefit from increased employment opportunities. Peru as a whole, however, will not gain any long-term growth or development if none of the profits are reinvested and no attention is paid to the environment.