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# South-South Policy Spaces and Tools

While China's move up the value chain is neither inevitable nor automatic, African countries need to not only consider threats from China's current (*static*) comparative advantage, but to identify the *dynamic* opportunities found in China's development wake. This brief argues that with much of China's present engagement with Africa being an externalization of its own modernization experiences in the past three decades, African leaders can exploit this rare opening to re-orient African policy frameworks towards their own "catch-up" national development.

The brief summarizes areas of "new" direct South-South policy space interactions found in the existing literature (mostly related to terms of finance), while also highlighting the indirect South-South transfer of certain renewed policy tools and institutions that are pivotal for industrial development, namely: capital controls, sovereign wealth funds, government ownership, and indigenous innovation. These spaces reflect, as Ramo (2004) foresaw, "Beijing's growing power of example".

This policy brief identifies distinct Sino-African interactions relating to direct and indirect policy spaces and tools that could be harnessed to reinvigorate African industrial development.

This South-South brief is the third in a series of three that examine the burgeoning economic relationships between **BRIC (Brazil, Russia, India, and China)** and African countries and their developmental implications.

It is common knowledge that African countries endured an earlier period of rapid economic reforms in the 1980s and 1990s due to policy conditionality imposed by international financial institutions (IFIs) – ie. the International Monetary Fund and the World Bank. Today, it is ironic that many analysts now lament the lack of policy space for African countries to engineer industrial development and their own move up the value-added production chain. As Sandrey and Edinger (2011) noted, "linkages need to be established between tariff and trade policies on the one side, and industrial policies on the other. In some cases (South Africa is the outstanding example), a combination of earlier unilateral liberalization and bilateral, regional and multilateral agreements have limited the policy space to nurture industrial development."

While few would deny that the IFIs and World Trade Organization (WTO) agreements are meant to restrict the role of government in the economy, this does not mean that there is no room for manoeuvre within the existing rules. There often remains more policy space than is sometimes believed within policy areas brought under WTO disciplines, as well as in areas that remain outside the scope of the WTO. However, exploiting such spaces is often linked to a government's ability to do so through adequate finances and institutional capacity. In many cases, such as exceptions granted to many low-income countries, there is more policy space than can be used given their financial constraints. As has been argued, "the degree of autonomy in these areas is greater for those middle-income countries that can escape donor conditionality than poor countries dependent on aid" (Akyuz 2007).

## Governance Norms

Analysis of the different channels of interaction of the "Asian Drivers Framework" has been uneven, with a greater number of studies focused on measurable direct/indirect impacts of trade, investment, aid and migration flows. This brief argues that South-South influence over economic governance norms of international institutions may be the hardest to measure, but it is also the most distinctive from North-South interactions; insofar as this feature could potentially enhance the policy spaces of other channels and thus have major consequences on the growth prospects of other developing countries.

In particular, China's unabashed use of industrial and financial policies to guide public and private sector investment and build domestic capacities in priority economic sectors goes against accepted global norms in economic policy-making. Yet China's approach may also demonstrate effective policy alternatives and offer strategic opportunities for African countries seeking to dynamically enhance and diversify their productive capacities up the value-added chain. Such strategic opportunities, for example, could extend to China's promotion of homegrown renewable energy technologies (Howell *et al.* 2010), which in turn could alter the composition of trade and investment flows, as well as assessments of environmental spillovers linked to these flows.

## New, Direct Policy Spaces

This sub-section briefly summarizes distinctive South-South features that help expand a given government's policy autonomy, especially in relation to terms of development financing, such as: loan conditionality (policy and non-policy), sectoral focus and mode of delivery, forms of support, and country portfolio and loan size. Below, selected features are further elaborated.

- ***Conditionality – Policy:*** The most distinctive feature of South-South ties is the lack of overt policy conditionality, a common feature of North-South relations whereby provision of aid or other financial flows is linked to acceptance by the recipient of donor preferences on what constitutes sound economic policy norms and practices. In explicitly attempting to shape domestic policy, policy conditionality can be wide-ranging in nature, for example, from macroeconomic fundamentals such as trade, fiscal, monetary and exchange rate policies, to microeconomic regulations, institutions and policies governing activities in individual sectors of the economy.

These conditions are justified on the belief that aid and other financial flows work best in countries that score highly in international indices of good governance and economic policies, which often equates good policies with less government intervention and greater degrees of economic and financial liberalization and privatization – i.e. the package of policies known as the Washington Consensus (UNCTAD 2010).

- ***Conditionality – Non-Policy:*** Countries like China and India often attach non-policy conditions to the disbursement of aid and financing, often linked to access to natural resources or the tied-purchases of goods and services that are supplied by firms from the country providing the aid/financing. On the one hand, such stipulations certainly impact the effectiveness of aid flows, but on the other hand, the conditions reveal the imperative of Southern partners to promote trade and investment through aid and financial assistance, while also ensuring mutual benefit to both parties (UNCTAD 2010).

Indicative of the different approaches of Southern and traditional donors, is the institution through which aid and financing is delivered. Southern partners often rely on their export-import banks to provide finance and promote commercial linkages in trade and investment, while traditional donors channel their funds through dedicated government aid agencies that have promoted the unbundling of aid with trade and investment activities. In China, concessional financing is generally channeled through the Exim bank, while development financing is conducted through the China Development Bank (CDB) (Gallagher *et al.* 2012).

- ***Sectoral Focus and Mode of Delivery:*** Although there is some overlap, another key South-South feature is the focus on providing assistance and financing in productive economic sectors such as infrastructure including energy, transportation, telecommunications projects, as well as sectors encompassing heavy industry, manufacturing, mining, processing, and agriculture. Traditional donor-recipient ties, building on initiatives like the Millennium Development Goals, tend to concentrate on delivery of social services such as in health, education, environmental protection, as well as on issues of good governance and public administration (UNCTAD 2010).

According to Lum (2009), roughly $33bn in Chinese economic assistance and related investment projects in Africa was reported over the 2002-2007 period. Of this total, 54 percent was linked to infrastructure and other public works projects, 28.5 percent went to the extraction or production of natural resources, and 2.5 percent was disbursed to humanitarian activities, technical assistance, and military assistance (15 percent was unspecified). By comparison, over the period 2005-2011 around 34 percent of World Bank loans are targeted towards productive sectors, with more than a third of loans going to areas such as health, social and environment sectors (Gallagher *et al.* 2012). Additionally, Southern partners tend to interact through specific projects, rather than provide support through more encompassing sector-wide approaches or general budget support that is common practice for traditional donors.

A key aspect of this feature is China's willingness to invest in value-added projects mostly viewed as "un-economic" by traditional investors, but seen from a longer time horizon from China's perspective. For example, in 2010, the China State Construction Engineering Corp. agreed to spend up to $23bn to build oil refineries and other petroleum infrastructure in Nigeria as part of China's efforts to secure 6bn barrels of crude reserves. Crucially, despite being Africa's leading energy producer, Nigeria imports nearly all of its refined fuel, which is domestically subsidized at a cost of $4bn a year – an amount equivalent to the government's entire capital spending budget (Burgis 2010).

## Renewed, Indirect Policy Spaces

In addition to the "new" policy spaces indicated above, four other tools should be considered as "renewed" parts of the policy toolbox: capital controls, sovereign wealth funds, government ownership, and indigenous innovation. While China did not invent these tools, its careful study of other country experiences and adaptation of these tools, reflects an *indirect* South-South interaction on policy space. Below, the critical issue of capital controls is further elaborated.

- ***Capital Controls:*** The advent and aftermath of global financial crisis in 2008 revived the debate over the role of capital controls – or capital account management – where conventional wisdom held that a liberalized capital account, and a floating exchange rate, ensured policy-makers control over an independent monetary policy (interest rates) and some degree of control to steer the economy.

With investors seeking to gain from advantageous interest rate differentials found in fast-growing emerging nations, these latter became increasingly concerned that the surge in capital inflows was temporary and could be quickly reversed, thus causing serious problems for their economies. Even the IMF, a longtime advocate of capital account liberalization, began changing its institutional view on this issue (and what it deems as the appropriate policy response): "following the crisis, policymakers are again reconsidering the view that unfettered capital flows are a fundamentally benign phenomenon and that all financial flows are the result of rational investing / borrowing / lending decisions. Concerns that foreign investors may be subject to herd behavior, and suffer from excessive optimism, have grown stronger;

and even when flows are fundamentally sound, it is recognized that they may contribute to collateral damage, including bubbles and asset booms and busts" (Ostry *et al.* 2010).

The re-thinking of capital controls was bolstered by strong growth performances of countries like China (and India) that practiced different degrees of capital account management, while also conducting managed floats of the exchange rate that is somewhere between a floating and a fixed exchange rate (Yu 2008). In China, this policy configuration allowed decision-makers to pragmatically shield the domestic economy from volatile capital flows in retaining greater degrees of interest and exchange rate independence. Macroeconomic stability, in turn, helped support a sustained rapid growth posture that tilted the economy towards fixed-asset investment, while a competitive exchange rate encouraged FDI inflows and export diversification.

## The Beijing Consensus?

Areas of "new" and "renewed" direct and indirect South-South policy spaces and tools are (re)surfacing in policy debates, essentially because of the dynamic qualities imbedded in China's development trajectory. China's engagement with Africa can be portrayed as the externalization of its own development stage and experiences of the past three decades, as seen in the emphasis on investment in productive capacities, infrastructure development and financing, special economic zones, and the role of the state in the economy. With this kind of powerful "new, yet different" partner, African governments are presented with rare openings to pragmatically re-orient their policy framework towards their own "catch-up" national development.

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