POLICY BRIEF

AERC COLLABORATIVE RESEARCH CHINA - AFRICA PROJECT

ISSUE NUMBER 6| NOVEMBER 2010

The Impact of China-Africa Investment Relations: The Case of Mauritius

Construction of the Jin Fei economic zone in Riche Terre, Mauritius

By Vinaye Ancharaz and Baboo Nowbutsing

Introduction

China provides an interesting case of a developing country that has emerged rapidly as a key outward investor even as it continued to attract foreign direct investment to its shores. China's outward investments are primarily natural resource-seeking, rather than efficiency-seeking. And, given Africa's rich endowment of oil and minerals, it is hardly surprising that the Chinese have turned to Africa. As a result, Africa has seen a dramatic increase in FDI flows from China over the past two decades. Chinese FDI stock in Africa has grown from US$49 million in 1990 to US$ 2.6 billion in 2006, and the momentum was hardly dampened by the recent financial crisis.

The scale of China's growing presence in Africa through trade, investment and aid channels has raised concerns about its possible adverse impacts on African development. In the case of investment, these fears are in part fuelled by the underlying motivations of Chinese FDI strategy in Africa. Besada et al. (2008) argue that the recent surge in FDI is a response to the Chinese government's strategic call for a "go out" policy launched in 2000. While the Chinese defend their aggressive investments on the grounds that they yield mutual benefit, promote common prosperity and support learning from each other, many researchers have attacked China's investment strategy as driven by greed and selfishness – that is, the need to feed the hunger for growth back home (Zafar, 2007).

More controversial is China's practice of bundling together aid, trade and investment, which reduces the real value of an investment project. The so-called 'Angola mode' – whereby aid and investment are paid back in oil – has become a framework for much of China's investment activity in Africa (Kaplinsky and Morris, 2008). This framework is objectionable on the grounds that, by minimizing the local content, it prevents African economies from effectively participating in major investment projects, which reduces not only the multiplier effect on income but also denies them the opportunity to learn and, ultimately, fully own the project.

Be what it may, African countries can see in China's spectacular rise an opportunity to unleash a virtuous circle of trade and investment-led growth long denied to them by a confluence of historical and political factors. Also, the timing can hardly be better as sub-Saharan Africa has witnessed a return to democracy and peace (Ndulu and O'Connell, 1999) and the region continues to record sustained high rates of economic growth. Foreign investment, and in particular FDI, is credited for various growth-enhancing benefits to the host country – including technology and knowledge spillovers, economies of scale and of scope, greater efficiency due to competition, creation of backward and forward linkages and access to marketing networks that foreign investors bring along with them (Blomström, and Kokko, 2003).

Mauritius' position is atypical of the rest of Africa. A small island with no exploitable natural resources, growing labour shortages, and poor and declining cost competitiveness, Mauritius offers an unlikely destination for the kind of FDI that the Chinese have generally privileged. Yet, Mauritius is the very first country in Africa to host one of the seven special economic zones that the Chinese government has promised to build around Africa. It is clear that the investment flows into the zone are neither market-seeking, nor resource-seeking nor indeed efficiency-seeking. What could then explain China's choice of Mauritius as a host of its industrial zone? This study argues that Mauritius boasts strong economic fundamentals and, through its various regional trade agreements and its strategic location in

the Indian Ocean as a bridge between Asia and Africa, offers the perfect gateway to the emerging African market. It is this opportunity, along with Mauritius' duty-free access to its traditional partners that China is eyeing.

Chinese FDI flows into the industrial zone, by their very magnitude and sectoral orientation (into high-value sectors such as pharmaceuticals and light engineering), are likely to have important impacts on the economy. The SEZ will generate jobs and foreign exchange earnings even though the real value to the domestic economy is expected to be smaller since the industrial zone is likely to be manned mainly by Chinese expatriate workers and export proceeds repatriated to China. However, Mauritius could gain from technology spillovers and linkages with the domestic economy. We provide a case study of the Chinese SEZ and examine carefully its potential impacts on the economy.

Finally, much of Africa's investment relations with China are unidirectional: FDI typically flows from China to Africa than vice versa. But, Mauritius has defied its small size to become an important investor in China, with a major spurt of investment in the textile industry by a Mauritian giant. But, whether that episode is a one-off affair or a harbinger of greater – and more diversified – investment flows is yet to be determined.

Objectives and Methods of Analysis

This study focuses on one of the vectors of influence through which China affects Mauritius – namely, investment – and seeks to provide an in-depth analysis of its magnitude, characteristics and impacts on the Mauritian economy. The specific objectives are:

1. To analyze the trends in, and magnitudes of, FDI inflows in Mauritius by sector and country, with particular emphasis on Chinese FDI;
2. To analyze the extent to which overall Chinese FDI inflows are bundled with aid;
3. To describe the regulatory regime governing FDI inflows in Mauritius and discuss whether it is conducive to attracting FDI generally and from China, in particular;
4. To analyze the characteristics of Chinese FDI, i.e., whether such FDI is through joint ventures or wholly owned subsidiaries, whether it is resource-seeking, market-seeking or efficiency-seeking, and whether the output is targeted at the domestic or external market;
5. To compare and contrast the characteristics and practices of Chinese FDI and FDI from other sources with a view to determining whether Chinese FDI is motivated by strategic considerations atypical of mainstream FDI;
6. To assess the economic benefits that arise from major Chinese FDI in terms of export expansion, reduction of import dependence, contribution to value added and employment, government revenue, etc, and to highlight any adverse effects;
7. To assess the spread effects, if any, of Chinese FDI to other sectors of the economy in terms of skill development and capability building, the use of local inputs, supply chain management and technology transfer;
8. To determine the features, size and sectoral distribution of Mauritius' investment in China (if any) and the nature of support, or lack thereof, that such outward investments have received from the home government as well as from Chinese authorities.

Our prime objective is to assess the impact of Chinese investment on the Mauritian economy. To our knowledge, no formal methodology exists to guide us in this exercise. However, in keeping with the general spirit of the Jenkins-Edwards (2005) methodology, one can argue that any assessment of the economic effects of FDI should at least consider the impact on such variables of interest as employment, value-added, exports and growth. These effects can be direct or indirect, complementary or competitive, and they may be quantifiable to various degrees.

The most direct effects are likely to be on employment and income. Exports will also be affected to the extent that FDI is destined to serve foreign markets, as in the case of export-processing zones. The net effects of FDI (Chinese or otherwise) will depend on the size and type of investment, the sector to which it is directed, the level of technological sophistication of the investment project and its capacity to create linkages with the domestic economy.

FDI is likely to be most beneficial when it is greenfield and export-oriented. If it is meant to serve the local market, then the investment should preferably be in sectors that the country is actively seeking to promote and should avoid direct competition with local producers. Moreover, FDI projects that generate knowledge spillovers and foster the development of backward and forward linkages with the domestic economy are particularly beneficial to the host country.

The indirect effects relate to long-term growth. Such effects are hard to detect, isolate and measure since they occur with unknown lags, are spread over several years, are buffeted by various other factors thereby reducing their significance in any given year, and are generated by spillovers that are inherently difficult to capture.

FDI may also generate negative effects, such as Dutch disease and the competitive challenge to indigenous firms when FDI is local market-seeking. With Chinese investment, however, additional concerns are likely to arise since Chinese multinationals are known to use their own, rather than local, labour and inputs, which reduces the multiplier effect of any FDI project on the local economy. Similarly, since the Chinese favour wholly-owned enterprises and tend to be secretive about their processes and ways of doing business, the potential for growth-enhancing knowledge or technology spillovers is greatly reduced.

In this study, however, we are unable to present an in-depth analysis of Chinese FDI in Mauritius both because investments from China have been historically small and irregular, and because we could not obtain detailed, firm-level data to gauge the real effects of Chinese investments in terms of job creation, value added and contribution to exports. We managed to obtain some data on Chinese firms in operation in Mauritius from the local Chinese Embassy but these were not up-to-date. Hence, in this study, we offer a rather descriptive analysis of data purged from various sources, and present a couple of case studies featuring major Chinese investment projects.

Summary of key findings

The key findings can be summarized as follows:

- Mauritius offers an attractive investment climate. The Business Facilitation Act and the Finance Acts of 2006 have brought about major reforms to the investment regime. Incentives have been rationalized and harmonized and a reduced, uniform corporate tax rate of 15% applies across economic sectors. These reforms have helped place Mauritius number 17 on the World Bank's Doing Business rankings in 2010. However, their impact on FDI is either ambiguous or too early to assess.
- Until 2004, FDI flows to Mauritius were small, irregular and unevenly distributed across sectors. A clear upward trend is noted in recent years. However, much of the FDI flows have been directed to services, especially property development, tourism and financial services.
- FDI inflows are concentrated in a narrow range of sectors and originate in a few, traditional partner countries – EU, USA, India and South Africa – with which Mauritius has strong trade relations. This suggests a close association between trade and investment flows in Mauritius.
- It appears that the largest amounts of FDI have flowed into relatively low-risk, high-return sectors like tourism and banking. The real sectors – agriculture and manufacturing – have failed to attract FDI on a sustainable basis. This may be due to the overall low cost competitiveness of the Mauritian economy, unfavorable geography (small domestic market and remoteness from the center of gravity) and systemic factors (lack of natural resources and the policy emphasis on services).
- Chinese investments have been small and erratic through the years. The main investments have been directed to the textile spinning sector and undertaken by Tianli Spinning (Mauritius) Ltd., a wholly owned Chinese subsidiary set up in 2002. This company has helped cut down Mauritius' imports of cotton yarn, but has created few jobs for Mauritians. However, the launch of the Jin Fei project in 2009 has resulted in a massive spurt of FDI from China into the special economic zone. Such flows are likely to continue over the next five years or so.
- China has implemented significant corporate tax reforms and rationalized incentives so that its FDI regime complies increasingly with WTO rules. However, a number of weaknesses persist. FDI procedures are complex, bureaucratic, often inconsistent, and non-transparent. Investment is encouraged selectively in certain specific sectors, but deterred in others. China ranked 89th on the World Bank (2010) list, and obtained very poor scores on several indicators.
- Agreements between Mauritius and China in the domain of double tax avoidance and investment protection seem to have been a catalyst for Mauritius' outward FDI to China, which has broken new ground in recent years thanks to the activities of one textile company – Compagnie Mauricienne de Textile Ltée. Although, in absolute terms, such investment has been small, accounting for a mere 1.6 % of China's total inward FDI in 2008, Mauritius is nevertheless the biggest investor from the African continent.
- Contrary to the documented practice in much of Africa, there is no evidence that Chinese FDI in Mauritius has been bundled with aid nor has such aid been given on the same terms as to other African countries (where aid has often been exchanged for rights to Chinese firms to exploit natural resources).
- China has provided loans on concessional terms with generous grace periods, flexible repayment schedules and with no conditions attached. On the downside, however, exclusive bidding by Chinese firms for some infrastructure projects financed by the EXIM Bank has resulted in collusive practices to the detriment of the recipient country, as was the case in Mauritius recently.
- Our review of the determinants of Chinese outward investments yields a mixed bag of evidence. While the evidence points quite conclusively that natural resources and large markets have been significant pull factors, there is some controversy about the role of institutions, with some studies suggesting that China favors investing in countries with weak institutions and high levels of corruption.
- None of the above factors is relevant in the case of Mauritius, which has no natural resources, is small (in absolute terms) and boasts a solid democratic tradition, the rule of law and strong institutions. Yet Mauritius has attracted large flows of FDI from China in recent years into the special economic zone, one of the few that China is setting up across the African continent, raising questions about the real motives behind China's investment strategy.
- The SEZ will house various high-value, cutting-edge technology industries that Mauritius has actively sought to promote but had not been successful so far. Thus, the SEZ could help Mauritius graduate to a higher technology plane.
- However, our analysis suggests that the SEZ, even when it becomes fully operational, will have little positive effects on the economy of Mauritius.

Policy implications

China's engagement with Mauritius through the investment channel raises a number of policy issues and implications. Before the launch of the Jin Fei project, Chinese FDI in Mauritius has been small and irregular through the years. The wave of FDI from Hong Kong-based companies into the nascent clothing industry in the mid-1980s helped Mauritius create thousands of jobs and generate a high rate of export-led growth over a long period, especially as local investors also joined in. However, the exodus of these firms in the years preceding the expiry of the MFA, which signaled the end of Mauritius' preferential access to the US market on which the foreign investors had concentrated their exports, led to a drastic decline in employment and exports. But the fact that the clothing industry recovered after 2005 means that Mauritius had not depended on the foreign firms to the extent that it appeared. Therefore, their true contribution to the Mauritian economy is likely to have been small.

Can this conclusion be generalized to Chinese investment in Mauritius? A clear answer could emerge if we did

a careful project-by-project analysis of Chinese FDI. We could not afford to do this since such investment has been small and concentrated in a few sectors. Our case study of Tianli Spinning suggests that the firm has indeed contributed to filling the fabric gap in Mauritius, thus helping to build a vertically integrated clothing industry capable of meeting stringent rules of origin. However, its installed capacity is rather small relative to the industry's total requirement in cotton yarn and the firm has been further marginalized by local investments in spinning and weaving operations. Moreover, softening of the rules of origin in the proposed Economic Partnership Agreement with the EU as well as the renewal of the third-country fabric derogation under AGOA, both of which will make it possible for local clothing exporters to source their yarn and fabrics from cheaper Asian suppliers, means that independent spinners like Tianli will the roles of diminish.

Our analysis of the Jin Fei project further supports our claim that Chinese investments are unlikely to have a significant impact on the local economy. The true motives for setting up such a massive industrial zone in a resource-poor, geographically isolated and high-cost country are unclear since the project is conveniently protected by a confidentiality clause, atypical and unprecedented in Mauritius' history of doing business with foreigners. The thesis that the Chinese see in Mauritius a gateway to the African market and beyond sounds unconvincing since any other African country can offer the same market access privileges plus other attractions, such as the availability of local inputs and cheap labour. Can Mauritius' experience and maturity make a difference? Perhaps. But then why would business-minded Chinese operators want to invest in Mauritius when local investors themselves are fleeing to nearby Madagascar? Or do the generous concessions offered by the Mauritian government to its Chinese counterpart override any other considerations? While a definite answer to these questions is not possible in the absence of further information on the Jin Fei project, our analysis puts together several compelling arguments that suggest that the economic benefits to Mauritius will be small relative to the start-up costs borne by the government and its agencies.

The SEZ will utilize predominantly Chinese labour and only a small fraction of the 40,000-plus jobs that will be created will actually go to Mauritians. Moreover, based on casual evidence on staffing patterns in Chinese-owned enterprises, we can expect jobs at the technical and management levels to be reserved for Chinese expatriates, with local workers crammed into low-paying jobs. The construction of the industrial zone is under way: the workers are predominantly Chinese, the contractor is Chinese and so also are most of the inputs and materials being used. This suggests that the investment, notwithstanding its scale, will have only a marginal multiplier effect on income in Mauritius. We also argued that both because of the low potential for technology spillovers from Chinese enterprises in the SEZ and for the development of linkages with the local economy, the Jin Fei project will yield small benefits to Mauritius even over the long term. While the government has justified the project citing the technological sophistication of the enterprises, local firms and the economy, are unlikely to benefit from it if the zone operates as an enclave.

Several points emerge from the above discussion about what should be done to maximize the benefits on the local economy from Mauritius' investment relations with China or to minimize any negative impacts. A priori, the following prescriptions merit consideration:

Balanced negotiations

The government should be aware that dealing with Chinese investors will not be business as usual. China is a developing country with relatively limited concern for corruption and human rights. Being Communist, the Chinese government is significantly present in all investment projects and often negotiates directly with the government of the country it wishes to invest in. The balance of power in such negotiations is skewed in favor of the Chinese given their economic might, and their hunger for economic prosperity. The Chinese firms are thus able to impose their terms on their weaker partners, who are often impotent in the face of the ever-present threat that the Chinese investors might simply turn to other countries, in a global race to the bottom, if they do not get a favorable deal. Mauritius, as a small economy, is particularly vulnerable to China's influence. But the government should ask whether compromising the country's open and democratic principles is a good price to pay for investment projects that may bring little in terms of direct economic benefits to the country. While Mauritius is small, it is also a mature economy and boasts a long tradition of industry and exports. Moreover, Mauritius offers economic and political stability to prospective investors; a permissive, hassle-free investment environment; a shrinking but skilled workforce; and good and reliable logistics that can compensate for the country's geographical isolation. Few African countries can match these benefits. Hence, Mauritius should find strength in the unique package of incentives that it can tender to potential investors, including China, and use its diplomatic experience to negotiate for mutual benefits.

Seeking investment projects that are in tune with the country's economic orientation

Mauritius, which is well set on the path of a services-oriented economy, should refrain from seeking investments in sectors it does not have a comparative advantage. This is particularly true of low-skill, labour-intensive activities, in which a combination of high wages and low productivity has eroded Mauritius' export competitiveness. Worker motivation in these sectors is also generally low as could be evidenced by the prevailing high rates of absenteeism. Even in the seafood industry, which the government is actively seeking to promote, operators are being forced to seek expatriate labour since Mauritians are reluctant to work odd hours and tend to be absent from work more frequently than foreign workers. Even if the government could secure more jobs for the locals, it is debatable whether Mauritians would want to work in an industry that does not offer better working conditions than the traditional sectors – clothing and seafood. The expatriate labour phenomenon, which has taken proportions atypical of a developing country like Mauritius, is being driven not by local labour shortages but rather by a shift of workers away from low-wage manufacturing

towards the burgeoning services sector. Consequently, the national FDI policy should be geared towards higher value-added services in the ITES-BPO sector, and in education, health and tourism, consistent with government's policy of developing Mauritius as a hub in these sectors.

Requiring Chinese investment and projects to use more local labour and inputs

Agreements on loans from the Chinese government to finance construction (including the building of the SEZ) and infrastructure development often include clauses that require the projects to be carried out by a Chinese contractor, using labour, materials and other inputs from China. These agreements leave little room for Mauritian workers and building companies to be involved in major construction projects, thereby minimizing the multiplier impact on the economy. Thus, while the government may gain through favorable terms of credit, the country loses out on the opportunity to generate higher value added. In future negotiations for funding with the Chinese, it is important that the Mauritian government demands that a given proportion (say 10% to 20%) of any project's workforce be sourced locally. Such local content requirements are common in FDI projects elsewhere, including in China. We are suggesting that the use of local inputs be negotiated rather than be imposed.

Promoting joint ventures and sub-contracting

While Chinese investors may bring superior technology and know – how to Mauritius, the local economy is unlikely to benefit from spillovers due to the mode of operation of Chinese firms. This would be a pity in the context of the Jin Fei project – which proposes to set up firms in high-technology sectors such as light engineering and pharmaceuticals – since Mauritius would miss a real opportunity for technological leap-frogging. The fact that the project will utilize little local labour, which, moreover will likely be limited to the factory level, and will be closed to Mauritian investors, means that the industrial zone will be operating as an enclave, sealing off any potential spillovers to Mauritius. If the government wishes to nurture any hope for the country to reap the benefits of technology and knowledge transfers from Chinese companies, it is imperative that the government negotiates with its Chinese counterpart to allow some space for Mauritian companies in the SEZ. In addition, or alternatively, Mauritius can push for joint ventures in select high-technology industries. There is scope for such negotiations since the Jin Fei project is not yet finalized.

Avoiding the prisoners' dilemma trap

There is an important policy lesson for the whole of Africa in the way it deals with Chinese investors. What gives the Chinese power to impose their terms on the countries they deal with is not so much their economic might than the absence of collaboration, and in some cases, sheer dividedness, among African host countries. Africa is engaged in a relentless race to the bottom to attract the biggest FDI projects. This competition entails a kind of prisoners' dilemma predicament where all countries clamour to offer the most generous incentives to woo the Chinese and are ready to make the most sacrificial concessions. If the same countries cooperated to adopt a common stance in their engagements with China, and agreed to limit incentives and concessions, on the one hand, while exacting more from the Chinese side, on the other, the entire continent would gain. Such cooperation is not difficult to achieve. The various regional economic communities already provide a forum for this kind of cooperation to emerge and to be solidified into a common line of action with the blessing of a Pan-African initiative such as the African Union/ NEPAD.

AFRICAN ECONOMIC RESEARCH CONSORTIUM (AERC)
CONSORTIUM POUR LA RECHERCHE ECONOMIQUE EN AFRIQUE

The African Economic Research Consortium (AERC), established in 1988, is a public not-for-profit organization devoted to advanced policy research and training. The principal objective is to strengthen local capacity for conducting independent, rigorous inquiry into problems pertinent to the management of economies in sub-Saharan Africa. In response to special needs of the region, the AERC Research Programme has adopted a flexible approach to improve the technical skills of local researchers, allow for regional determination of research priorities, strengthen national institutions concerned with economic policy research, and facilitate closer ties between researchers and policy makers. The Training Programme augments the pool of economic researchers in sub-Saharan Africa by supporting graduate studies in economics, as well as improving the capacities of departments of economics in local public universities. AERC is supported by donor governments, private foundations and international organizations. Further information concerning AERC and its programmes can be obtained from:

The Executive Director
African Economic Research Consortium
Middle East Bank Towers, 3rd Floor
Milimani Road
Tel: (254-20) 273-4150 (pilot line) / 273-4157 / 273-4163
Fax: (254-20) 273-4173
Email: exec.dir@aercafrica.org
Website: www.aercafrica.org

www.aercafrica.org