The Impact of Changing EU-China Trade Dynamics on South Africa

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Abstract

Over the last century, the world has become increasingly interconnected, as globalisation has led to the expansion of the traditional market place. The result of this interdependence is that domestic economies are increasingly affected, both directly and indirectly, by changes in the economic position of foreign nations. This paper set out to determine which areas of the SA economy are likely to feel the greatest knock on affects from changes in trade dynamics between the European Union and China. The research paper finds that South Africa, like many emerging economies, is most vulnerable to external shock transmission through the commodity price channel. As commodities make up the largest proportion of SA exports. Further, SA is likely to impacted by any slowdown in China's growth, as it is SA's most significant trading partner. Other transmission mechanisms include direct trade flows, direct financial flows, foreign direct investment and exchange rate adjusment.

Keywords: Trade Dynamics, EU, China, South Africa, Spillovers

JEL classification

1. Introduction

Over the last century, the world has become increasingly interconnected, as globalisation has led to the expansion of the traditional market place, and the transformation of macroeconomic environments. The result of this interdependence is that domestic economies are increasingly affected, both directly and indirectly, by changes in the economic position of foreign nations. For emerging economies such as South Africa (SA), this affect is more evident as changes in SA's largest trading partners such as BRICS or the European Union (EU), have a greater long run impact on the economy than domestic decision makers. As a primary commodity net exporter, SA is particularly susceptible to shocks and spill overs from these nations. Therefore, in a rapidly globalising society, in order to ascertain future economic prospects of nation, it becomes increasingly important to engage with the channels and mechanisms through which SA will be affected by external developments. This paper focuses on the evolution of trade within South Africa and between its two large trading partners, the EU and China. Section 2 introduces the concept of globalisation and the importance of understanding interlinkages between economies. Section 3 provides an overview of South Africa's current economic position and

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details of how current trade dynamics have evolved. Section 4 looks at SA's largest trading partners as well as its export composition, to provide insight on where SA is exposed to risks from foreign developements. Section 5 and 6 introduce the external environment and focus on the current trade position of China and the EU, respectively. Section 7 focuses on the trade dynamics between China and South Africa. Section 8 provides insights into the channels and mechanisms through which unexpected shocks in foreign economies may translate through to SA, specifically, focus is placed on direct trade and financial flows, the commodity price channel and the exchange rate adjustment channel. Section 9 concludes.

2. Globalisation

Bhagwati (2010), defines economic globalisation as the integration of national economies into the international market through trade. Globalisation essentially describes the expansion of the global market place, and the increase in trade, capital, and human capital flows, as well as investments, across national borders. While the definition of globalisation may be disputed, the evidence of increasing interdependence cannot (Kastelle et al., 2006). For emerging markets, the economic positions of their largest trading partners frequently have a greater impact on their economies than domestic decision makers. It is important to understand the direct and indirect impact of these changes, as well as the magnitude of their affect. The Global Financial Crisis (GFC) of 2008/9 exposed some of the negative consequences of interconnected markets, as a global recession evolved from an American mortgage crisis. The ripple effect of the recession took place through multiple channels affecting each economy in a unique way. The GFC was followed by a sudden and unprecedented contraction of world trade (Baldwin, 2009). This contraction can be explained partially by a reduction in the supply of trade finance, as developed nations struggled to find the liquidity to sustain previous levels of trade (Freddy et al., 2019). This liquidity crunch particularly impacted emerging markets, and lead to sudden stops in investment and large reductions in exports. In spite of this episode, over the last 50 years, the majority of emerging markets have seen significant increases in manufacturing export trade, and foreign direct investment (FDI), as a proportion of their GDP (Kastelle et al., 2006). In addition, there has been increased integration of capital labour markets across borders (Ghemawat, 2003). These represent a few of the multitude of channels which expose domestic economies to changes in foreign economic positions. All of these channels have spill over affects which means changes in capital flows and trade dynamics affect a variety of macroeconomic factors such as exchange rate volatility and inflation. These examples of economic interlinkages all represent channels through which foreign economic activity may help or harm a domestic economy. However, the multitude of both complementary and opposing forces, in either direction, make this discussion incredibly nuanced when analysing even a simple bilateral relationship. Therefore, the for the purpose of this paper, focus will be placed on the impact of changes in trade dynamics between SA and its largest trading partners. While the GFC literature presents examples of how economies impact one another in the short term, this paper focuses on how south Africa has been, and may be, impacted in the long run.

3. South Africa's Current Economic Position

International trade is a major driver of growth in all countries. This concept, referred to as the export-led growth hypothesises, has been tested extensively in previous literature which finds that in SA, exports have a strong and significant positive relationship with real growth (Jung and Marshall, 2015). Over the last 5 years SA has experienced depressed growth rates, with GDP per capita growth averaging around 0% since 2014 (World Bank, 2019). GDP PC growth has stagnated due to population growth rates, and poor economic activity. This stagnation can be seen in Figure 3.1.

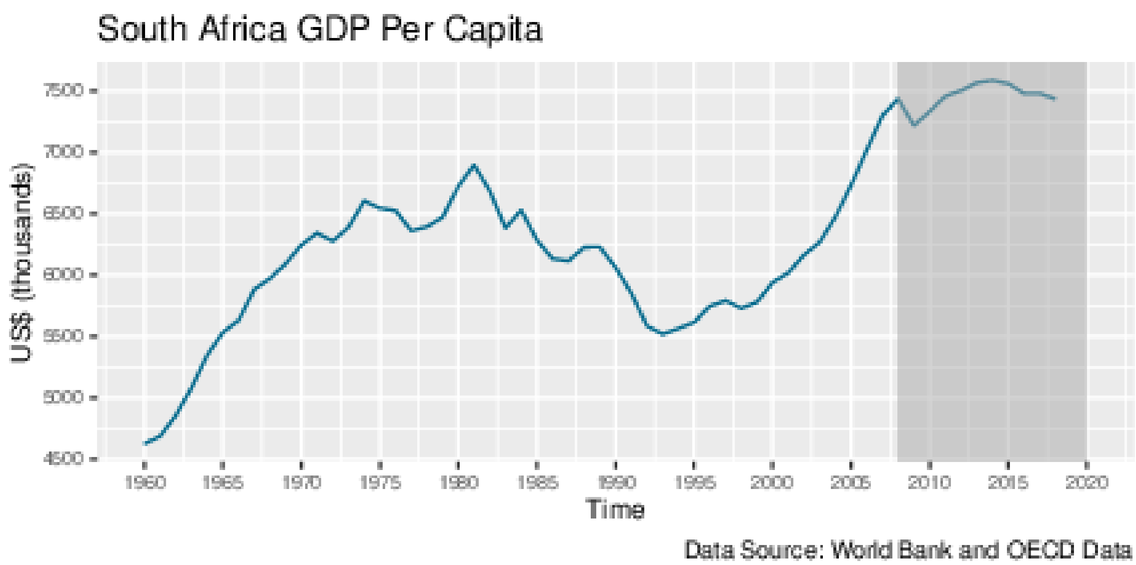

Figure 3.1: South Africa - GDP PC 1960-2019 in Constant 2010 US Dollars

Since the 1960's South Africa's real economic growth has not exceeded 6% (Edwards and Lawrence, 2008; Freddy et al., 2019). In 2019, GDP growth in SA was estimated to be a mere 0.4%, which is a 4 percentage point decrease from 2018 (World Bank, 2020). GDP growth is expected to rise to 0.9% in 2020, and thereafter to 1.3%, in 2021 (World Bank, 2020). However this estimated increase is conditional on policy makers following through with planned structural reforms, therefore reducing policy uncertainty, as well as, the recovery of public and private investment. The World Bank, (2020) predicts that domestic growth will be slowed by infrastructure constraints in electricity supply as well as by weakened external demand for SA exports (World Bank, 2020). In 2018 South Africa's GDP, in current US dollar prices, was roughly 366 Billion (StatsSA, 2019).

Export expansion, import substitution and international capital movements have all been important in the development of SA economy (Mohr and Fourie, 2008). International trade accounted for about 60% of SA GDP, indicating that SA has a very open economy and that trade remains incredibly important for its growth prospects (Santander, 2018). As of 2017, it was the 34th largest export economy in the world (Simoes, 2018). SARS reported that in December of 2019, total exports reached 7.2 Billion dollars while imports were roughly 6.1 Billion dollars, making it a net exporter that month (SARS, 2020). However, Edwards and Lawrence (2008), report that since the 1960's, import volumes have been steadily increasing compared to export volumes. As, SA fluctuates between being a net importer or exporter of goods, changes in trade dynamics in both directions are equally important (CEIC, 2020).

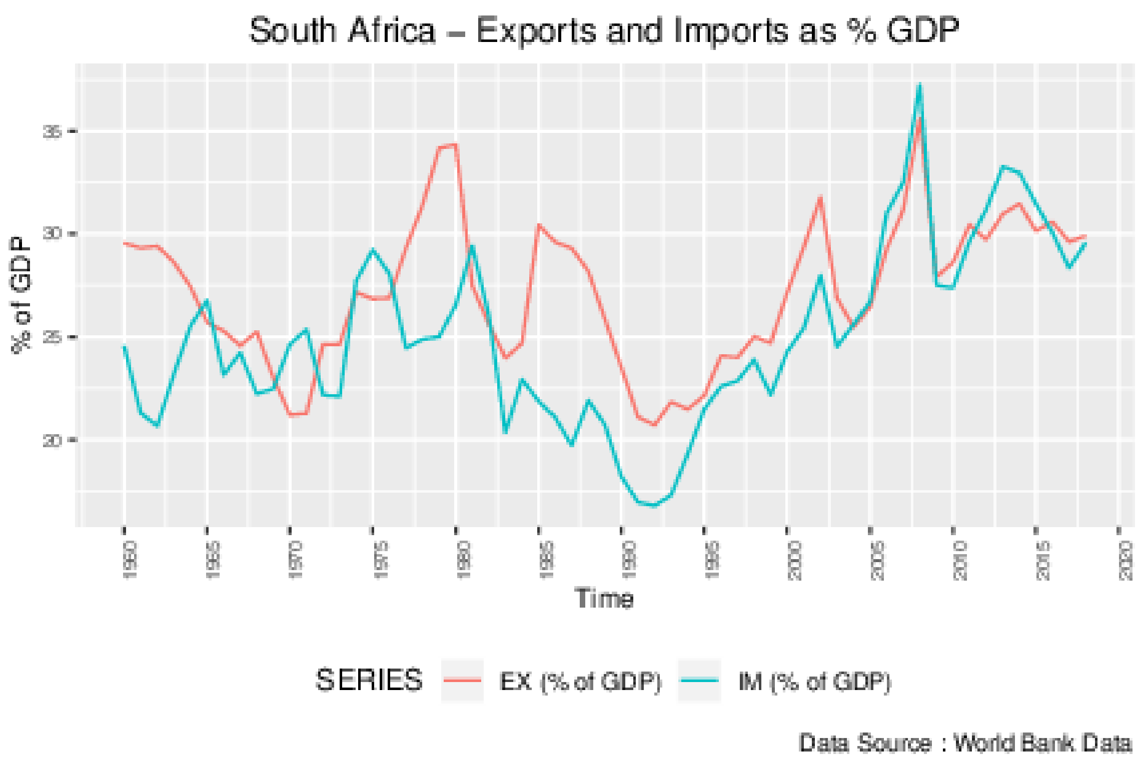

Figure 3.2: South Africa Exports and Imports

Figure 3.2 indicates the evolution of SA exports and imports since 1960. Trade liberalisation in the 1990's dramatically increased trade in both directions for SA. Since 2009, SA has seen slow export recovery and moderate import recovery. Figure 3.3 indicates that SA fluctuates between a net exporter and net importer. The Figure further indicates that SA's trade position is incredibly volatile and contingent on external environments.

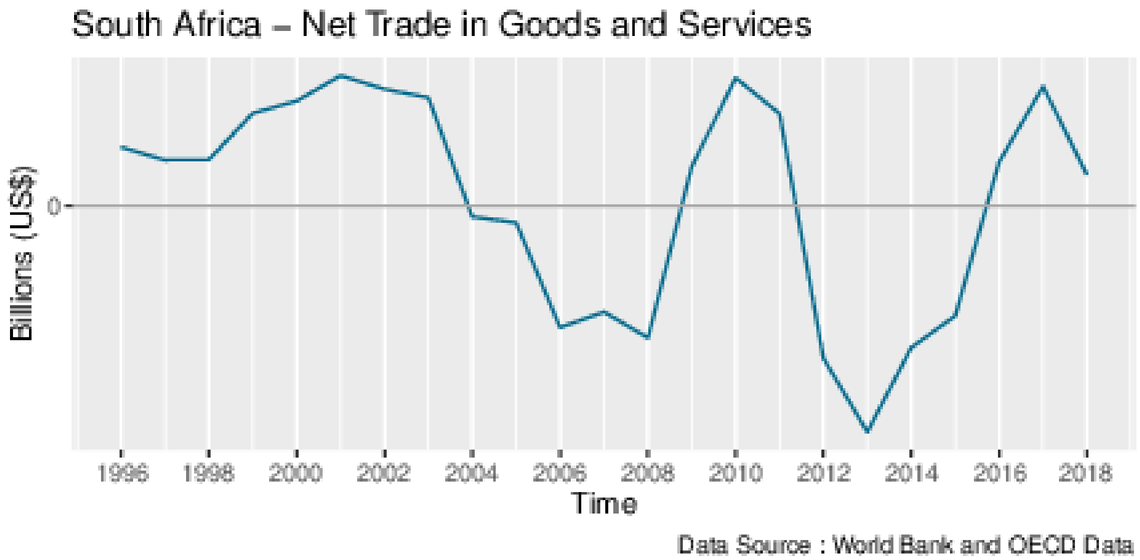

Figure 3.3: South Africa's Net Trade in Goods and Services

Over 1970 and 1991, real GDP increased by 54% while the real exchange rate was a similar level in both years. Import volumes over this period were relatively flat, possibly due to protectionism and political sanctions. Non commodity exports were also relatively flat, while non gold commodity exports increased steadily. Over this period, world trade increase by 90% and world GDP by 70%, indicating that comparatively, SA did not benefit from globalisation over this time (Edwards and Lawrence, 2008). Between 1991 and 2001, import volumes grew by 73% and export volumes by 70% respectively. Reductions in gold exports volumes (by roughly 30%) were offset by the 50% increase in exports of other commodities and a 200% increase in non-commodity exports (Edwards and Lawrence, 2008). Over this period exports grew by 5.7% while manufacturing exports grew by 7.8% per year. Trade liberalization in 1990's played a large role in increased export revenues.

In the early 2000's, productivity growth in commodity exporting countries as well as increases in commodity prices, lead to higher export revenues which aided in reversing the 20% decline in productivity over the final decade of the Apartheid. SA benefitted from substantial investments in commodity production and exploration, as an oil and metal exporter (Khan et al., 2016; Schodde, 2013). During this period, exports rose as a result of this increased productivity as well as from an improvement in policy frameworks, increased trade openness and foreign capital inflows resulting from the transition to democracy (Du Plessis and Smit, 2007). Between 2000 and 2005 import volumes increased dramatically each year, as SA sourced mostly durable goods. Automobile imports rose at 23.5% per year over the period and commodity imports by 8% per annum. In the same period, export growth in both commodity and non-commodity goods was slow, however growth exports of services averaged 8.6% (Edwards and Lawrence, 2008).

Since 2008, SA economy has been slowly stagnating, achieving low levels of growth as well as underwhelming export revenues. Contractions in the mining and manufacturing sector have played a large role in slower export revenue growth as the manufacturing sector decline by 8.8% in 2019 (World Bank, 2020). Structural change is desperately needed to diversify South Africa's revenue stream as its dependence on commodity exports have led to increasing exposure to foreign risk.

4. Trade Partners and Export Composition

South Africa's largest trading partners include China, the United State of America, Germany, Japan, India and Saudi Arabia (Santander, 2018). In addition, continuing negotiations around the African Continental Free Trade Area present an avenue for potential increases in regional trade. In terms of exports, South Africa's largest export trading partners are, China (17.1B), the USA (8.21B), India (8B), the UK (7.97B) and Germany (7.05B), where parenthesis indicate the value of exports in US dollars to each nation in 2017 (Simoes, 2018). In terms of imports, China (15.6B), Germany (7.23B), the UK (5.49B), India (4.28B) and Saudi Arabia (3.89B) represent SA largest import trading partners (Simoes, 2018). Clearly China is an incredibly significant trade relationship for SA.

Historically, commodity prices and external commodity demand, have had a large impact on SA trade and growth, as it is a major exporter of minerals and a large importer of oil. In particular, SA is still heavily reliant on gold, diamond, platinum, cars and coal briquettes. These items made up for 48.83 Billion dollars of exports in 2017 (Simoes, 2018). SA predominantly imports crude petroleum, refined petroleum, cars, gold and broadcasting equipment. To the value of 21.06 billion dollars in 2017. The composition of trade in SA, and its evolution over time, indicate the areas in which SA is exposed to external risk and foreign developments. A sharper than expected deceleration in major trading partners, such as China, the EU, or the US would substantially decrease expected export revenues and investment, as these economies account for 40% of the export revenue generated in Sub-Saharan Africa (World Bank, 2020). In addition to this exposure, China accounts for one half of global metal demand and one quarter of global oil demand, therefore an unexpected or fast, slowdown in china's growth, would cause a sharp fall in commodity prices. Creating a problematic environment for SA export growth. The World Bank predicts slow GDP growth for 2020 and 2021, stating that weakening external demand particularly from the Euro area and China, would deeply impact SA export volume, and that fiscal revenues are dependent on these sectors (World Bank, 2020).

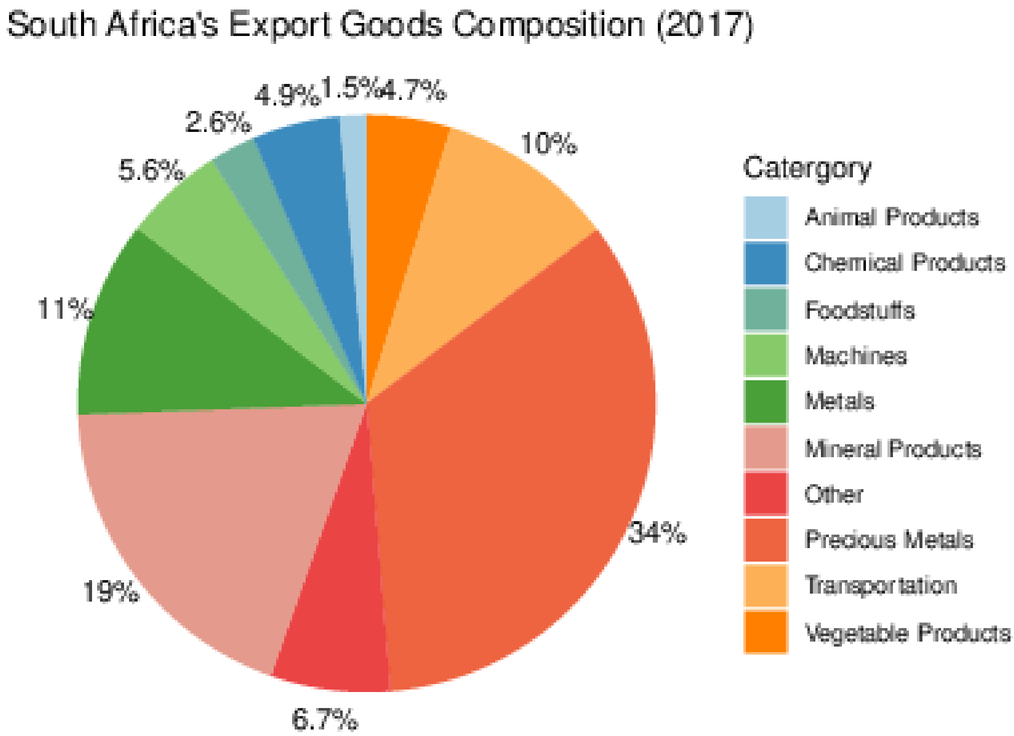

Figure 4.1: South Africa Export Composition 2017

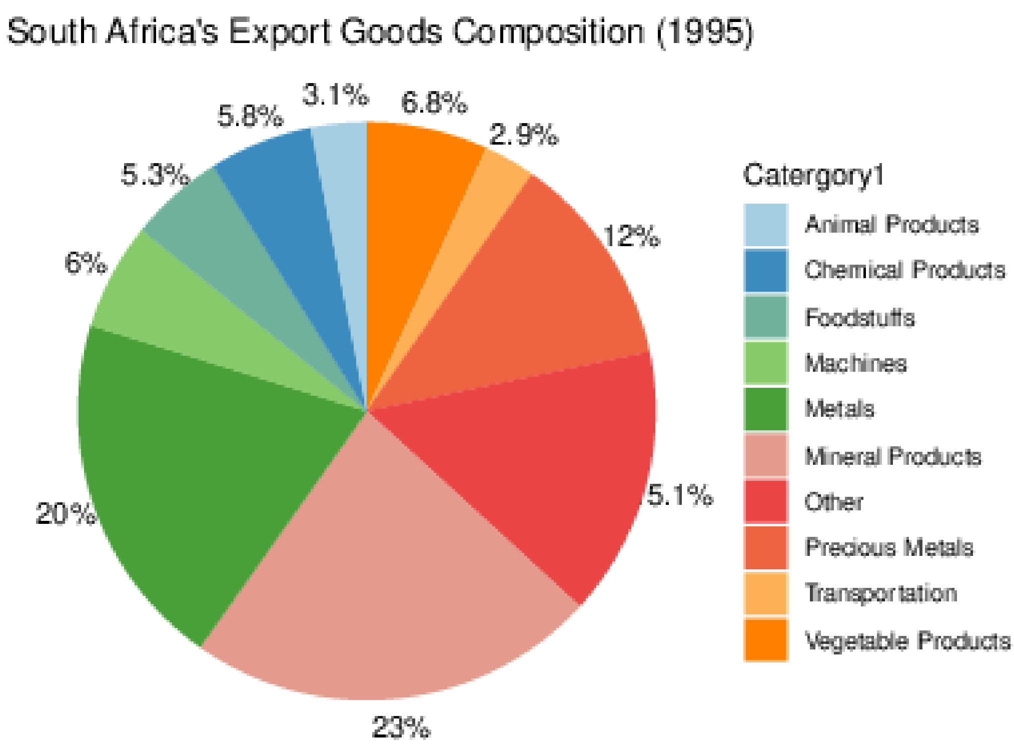

Figure 4.2: South Africa Export Composition 1995

Figures 4.1 and 4.2, demonstrate the change in SA's export composition over the last 2 decades. The data is sourced from World Trade Organisation databases and compiled by the OEC. The figures indicate that over the last 20 years SA has managed to reduce its dependency on mineral products and metals, however it has become more dependent on precious metals, predominantly, gold, diamonds and platinum, which made up for 33.3% of all exports in 2017. The size of SA's transortantion export market has significantly increased while the exports of animal products, chemical products and foodstuffs has shrunk. Figure 4.2 indicates that SA is still reliant on their extractive sectors for exports. Overall, export composition is dominated in primary goods, commodities or minerals. The import market is dominated largely by manufactured goods and oil (Alence, 2015; Claar, 2018).

In addition to export cmposition, the history of SA's terms of trade give an indication of global economic health, as the index essentially reports an economy's international buying power. SA's terms of trade is giving in Figure 4.3:

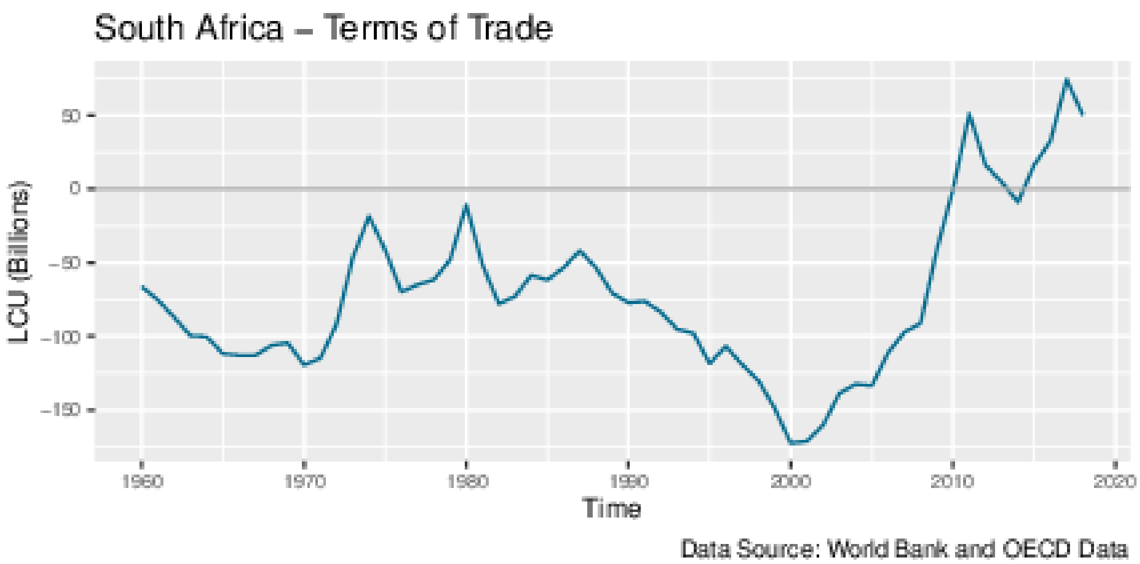

Figure 4.3: South Africa's Terms of Trade between 1960 and 2018

Terms of trade is an index of the ratio between import and export prices. The variable gives an indication how competitive an economies trade prices are. Where terms of trade rises, this indicates that exports are more expensive and that imports are cheaper, which leads to an improvement in living standards. Frequently, a deterioration in the terms of trade index is preceeded by a devaluation in the Rand. Appreciation in the exchange rate will improve the terms of trade index. Since the 1960's, terms of trade in SA has been volatile, where it steadily declined between 1980 and 2000 and then rose in the early 2000's (Edwards and Lawrence, 2008). As commodity prices fall, SA seas a deterioration in its terms of trade, this is evident between 2011 and 2015, where comoddity prices were dropping.

5. China's Current Economic Position

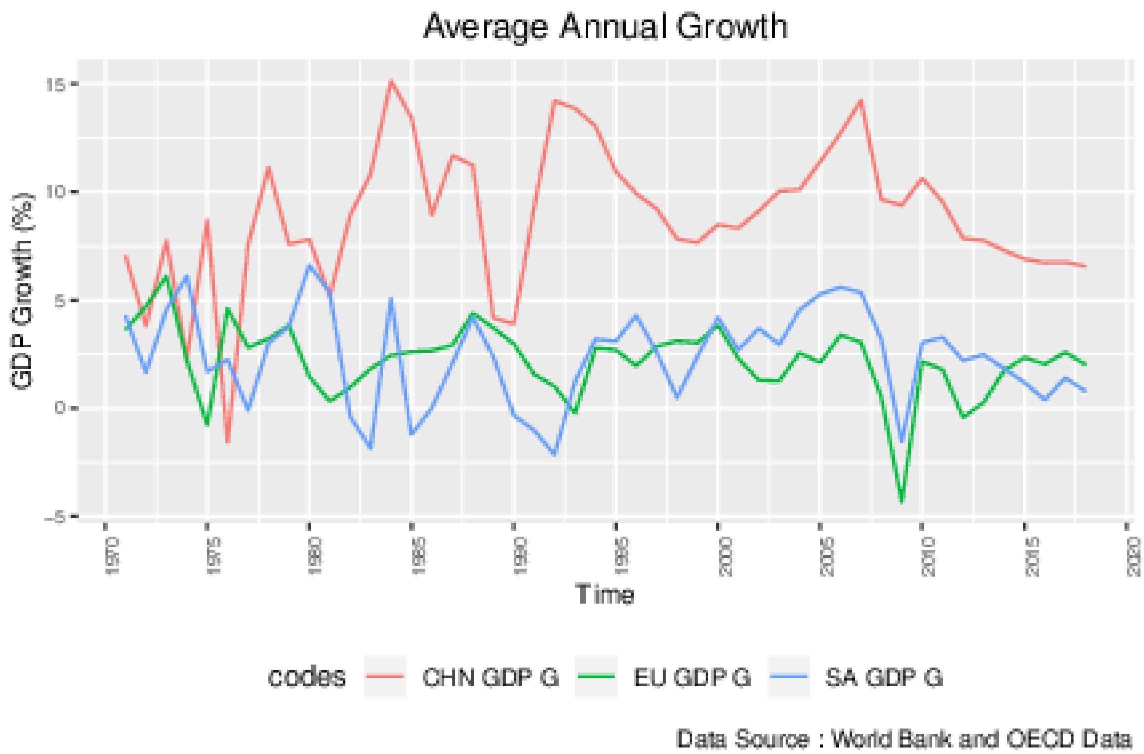

Figure 5.1: Growth in GDP 1960-2019

Over the last few decades, China growth rates have been astounding. Fast and dramatic growth in the East Asian nation has fundamentally changed the global dynamics of trade (Woetzel, 2019; Paus et al., 2009). The IMF estimated that China's GDP was roughly 14.3 Trillion dollars in 2019 (IMF, 2020). GDP growth in China has averaged around 6% in the last 30 years. However, since the GFC China's debt to GDP ratio has been climbing (European Comission, 2015), therefore increasing global exposure to Chinese credit risk. Figure 5.1 provides an indication of the major discrepancies in GDP growth rates between China, SA and the EU. Export and Import Growth have also significantly grown over the last 50 years.

Figure 5.2: China Export and Import Growth

China successfully positioned themselves as an upcoming economic giant through favourable trade policies, that stimulated exports and production. Chinas interventionist policies such as domestic subsidies and exchange rate control have enabled it to control its terms of trade. In addition to government intervention China has, over the years, negotiated favourable trade deals with most of the major economies, gaining low tariff exporting opportunities (Paus et al., 2009). However, incredibly high growth rates have been difficult to sustain in recent years, given increased global trade tensions. Rising tensions between China and the USA administration particularity hampered export growth in 2017, and slowed down GDP growth to (a still impressive) 6.1% in 2019 (World Bank, 2019). Rising tensions broke out into a full trade war in 2018 which were followed by complicated negotiations as the US attempted to strongarm China into changing trade terms (Woetzel, 2019). Historically the EU has been an inadvertent beneficiary of US-China trade tensions(Satander, 2018). However, in the wake of the trade war, Europe capitalised on the opportunity to negotiate more favourable trade agreements with China. The expected slowdown in China in 2020, may be temporary, if trade deals are being negotiated for economic, rather than political reasons. If the US-china trade war is predominantly politically motivated to the limitation of China's rise as an economic power, then one would expect the tensions to be long lasting and for growth to slow over the next few years. This would have a great impact on many emerging markets both in Africa and Asia. High export growth has only been sustained by ever increasing demand for manufactured goods in all regions. The USA and the EU are the largest consumers of these goods. As demand for manufactured goods decreases from the trade war or alternatively price of imports increases as a response to the trade agreement, there will be slower than expected increase in imports in China. The rise of China has greatly benefitted SA thus far, however an expected slowdown in Chinas growth could impede SA export growth.

6. The European Union

The European Union holds many of the world's major economies such as Germany and the United Kingdom. This free trade region creates much of the demand for manufactured goods.

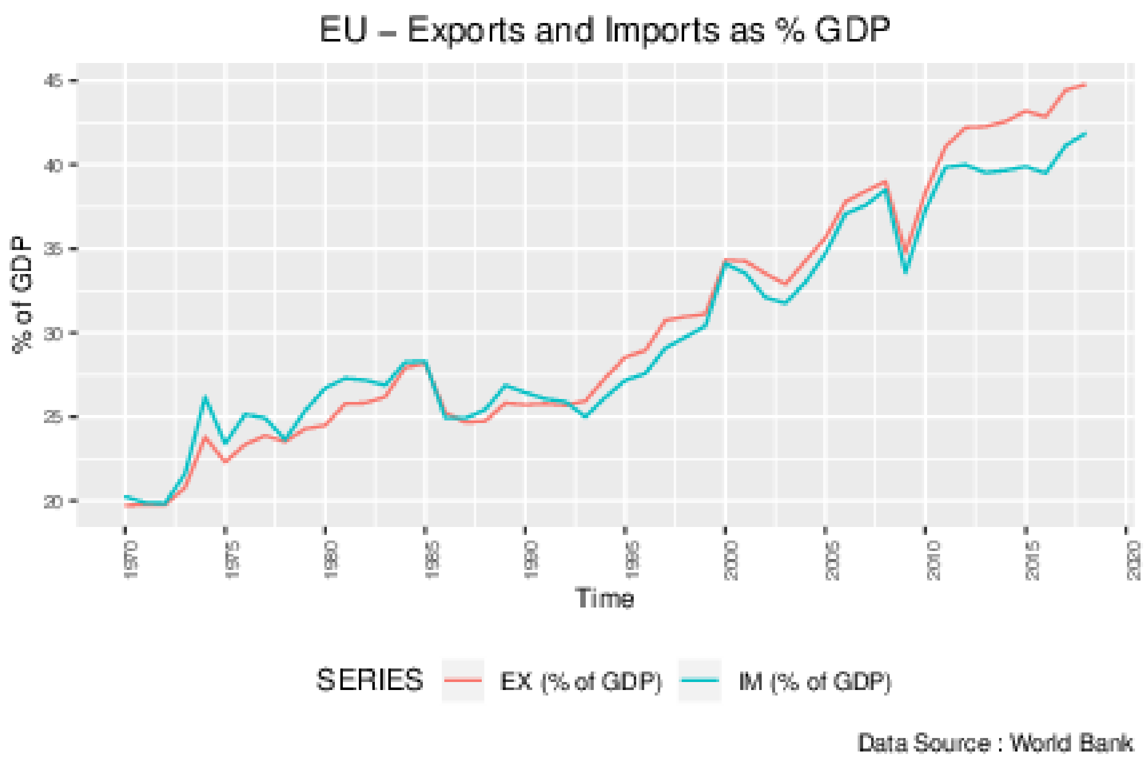

Figure 6.1: Europe Export and Import Growth

The EU is another one of SA largest trading partners. Recently SA signed the Economic partnership agreement (EU SACD) to replace the trade development and cooperation agreement, incentivising freer trade between the regions (Mhaka and Jeke, 2018). South Africa's trade relations with the Euro Area changed significantly after the Apartheid Era. Between 1990 and 1994 the abolishment of sanctions meant the EU opened its market for industrial products, with the exception of coal and steel, under the General System of Preferences (GSP) in September 1994 (Claar, 2018). The strategic partnership developed after the cold war when there was incentives to open trade (Masters and Hiero, 2017). In the early 1990's trade agreements between the EU and SA were favourable to the latter, as the new regime negotiated both developmental and cooperation elements as well as a free trade zone. The negotiations resulted in regulated duty and tax free exports in the industry and agricultural sector. 95% of goods could be exported to the EU tariff free, while the EU could export 86% of goods tariff free (Grant, 2006). In addition, SA negotiated for technical support in policy implementation, as well as access to cheap loans and support of financial structures (Meyn, 2003). While the imbalance gave SA a significant advantage, overall the agreement stimulated trade between the regions and significantly opened the markets. As of 2007, SA joined the EU-SADC EPA group which is a multilateral trade agreement between the Euro area and Southern African economies (Weismann, 2005). The agreement was signed in 2016 to negotiate regional integration (Claar, 2018). The EU also has strong trade ties to China. Europe is a net importer from China, however there is significant bilateral trade in each direction estimated at over 1 billion Euros per day in 2019. China is the EU's biggest source of imports, as well as the second biggest source of exports. While EU-China trade relations have been changing, as Europe took a more offensive stand in negotiations in 2019. China remains the EU largest supplier of industrial and consumer goods such as machinery and equipment, and footwear and clothing.

7. China and SA Trade Dyanmics

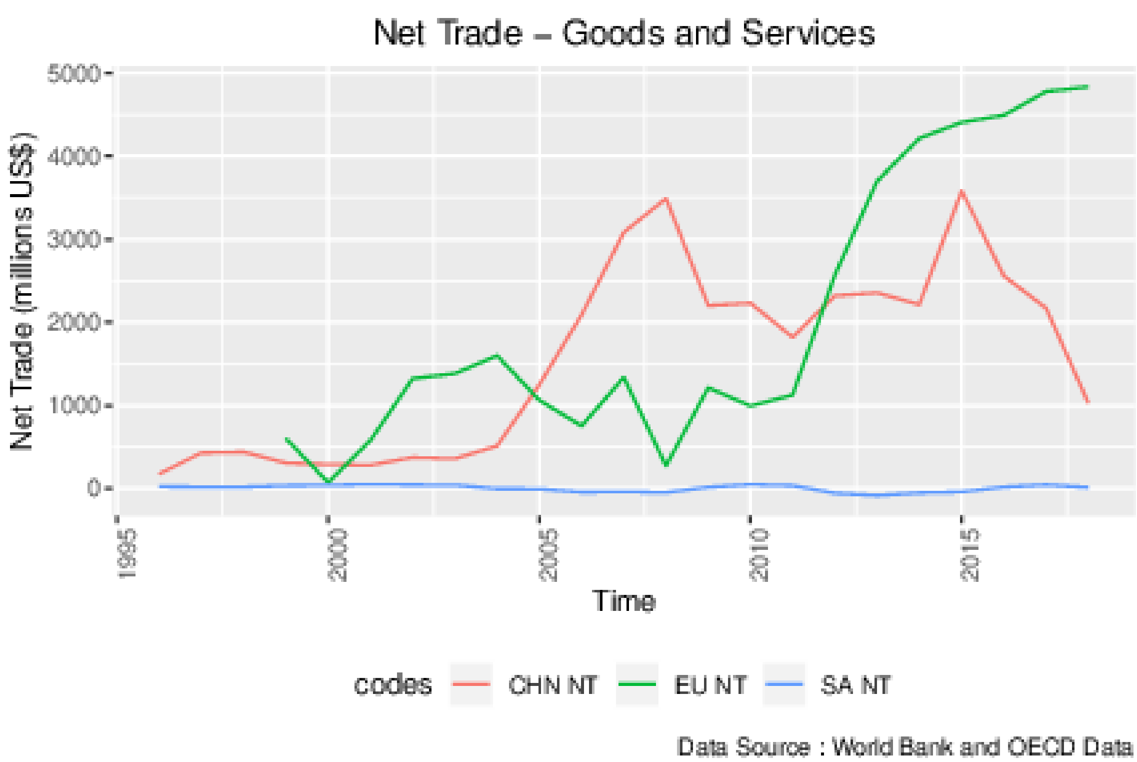

Figure 7.1: Europe Export and Import Growth

Figure 7.1 indicates how closely linked global economies have become in trade movements. It also shows the large discrepency in the manitude of trade between SA and China and the EU. South Africa's dependence on China for trade is particularly evident as Chinas net trade appears to be a lead to SA's. The same could possibly be argued of Europe's and Chinas relationships except for certain periods such as 2005 and 2010, where China and the EU's trade move in opposite directions and where clearly SA net trade movement is predominantly affected by Chinas. Since 2008 net trade in SA has been declining, frequently facing a trade deficit which is financed either through borrowing or savings, to stabilise the economy. As SA trade so closely mimics that of Chinas, one can expect any adjustments in Chinas economic position to also affect SA similarly.

The trade relationship between China and SA has been developing since the establishment of the Peoples Republic of China in 1998. Since this time, numerous trade agreements have been negotiated that have established a strong bilateral trade agreement between the countries as well as opened trade channels between informal groups such as BRICS (Grimm et al., 2014). A strategic partnership was declared in 2004 and a programme for a deepening strategic partnership was established in June 2006 (PMG 2010, in Grimm et al. 2014). The formation of BRICS gives SA a significant position in continental and even global affairs (Alden and Yushan, 2014; Mhaka and Jeke, 2018). BRICS is an intergovernmental organization including, Brazil, Russia, India, China and finally South Africa after its integration in December 2010. Referring to the GDP ranking of countries according to the IMF in 2018, China, the world's leading economic power with USD 25 270.07 billion, is at the top of the group, followed respectively by India (USD 10 505.29 billion), Russia (USD 4 213.40 billion), Brazil (USD 3 365.34 billion) and South Africa (USD 789.42 billion). In the case of South Africa, the importance of its BRICS membership goes beyond the economic aspect and is rather perceived as "the integration of an association of countries sharing the same values attached to their independence and wishing to reform the global decision-making structure" (Shubin, 2015 in Freddy et al., 2019).

The trade relationship between SA and East Asian countries has always been strong. In 1990 17% of SA imports stemmed from East Asian countries such as China, Japan and Taiwan. This number increased to 20% in 2009 and has been steadily growing ever since (Mhaka and Jeke, 2018). Exports to East Asia over the same time period grew from 13% to 21%. However, the sudden and dramatic economic growth in China, as well as the strong political and economic ties it has to SA, has culminated in China being regarded as SA's most important trading partner (DTI, 2010; Mhaka and Jeke, 2018). The substantial value of exports and imports exchanged between SA and China suggests that SA has become increasingly exposed to changes in the Chinese economy. Since 2009 China has been SA's largest trading partner but the trade balance is in favour of the former (Ensor, 2014; Mhaka and Jeke, 2018). The unique partnership operates at a bilateral, continental and multilateral level.

Since the end of the global financial crisis the trade flows between China and South Africa have been increasing (Mhaka and Jeke, 2018). Exports to China have increased from about R2.7 billion in 2009 to R11.8 billion in November 2019 (DTI, 2020). Roughly, 90% of SA's top 10 exports to China are comprised of raw materials. These exports are primarily commodities such as ores, slag and ash, iron and steel, wood pulp, gems precious metals and coins, wool, oil, copper, plastics, machines engines and pumps, and nickel. SA has an abundance of mineral resources (Alden and Yushan, 2014), which China imports as inputs for their manufacturing industries. The output from these industries is sold back to SA. This bilateral agreement is strengthened by comparative advantage that forms the basis of their trade. In many years, SA's export performance to China have been fluctuating but remained positive except during 2008–2010 as shown by Mhaka and Jeke (2018). The majority of SA imports from China stem from the secondary sector where China has a comparative advantage. Imports from China are predominantly electronic equipment, machines, engines and pumps, footwear , clothing, furniture and lighting, iron or steel products and vehicles (Mhaka and Jeke, 2018).

8. Multilateral Trade Dynamics between SA, China and the EU

In a globalised society, shocks and spill overs translate among all economies. The consequences of an interconnected world can be positive or negative. There exists a multitude of complicated linkages between these economies, some of which are direct, and easily measured, and others which are not simple to quantify. Frequently, the indirect impacts are much more substantial than the direct impacts (Kaplinsky et al., 2010).

The main channels through which SA is exposed to changes in foreign economies are, direct trade flows, direct financial flows, the commodity price channel and exchange rate adjustments. In addition they may impact SA through the environment, technology transfer and integration of value chains or through participation in institutions of regional and global governance (Kaplinsky et al., 2010). When analysing how impacts translate through these channels, forecasting potential outcomes and the magnitude of affect becomes onerous. As the spill over mechanisms are sometimes complimentary and other times represent opposing forces. This becomes particular difficult when analysing multilateral trade agreements. For example, a unexpected stagnation in Chinas growth could mean a dramatic decrease in SA's export revenues, and a significant depreciation of the Rand as its linked closely to the movements in the Yuan. However, if the EU responded to the new sentiment by moving demand to Sub-Saharan Africa, then it could result in a large increase in imports from SA, which could offset the sudden stop in Chinas demand for SA commodities. Therefore, the indirect impacts occur as a result of relations with third parties working their way indirectly through to SA. As demonstrated, the discussion has a tendency to become overly hypothetical, therefore for the purpose of this paper, focus is placed on the channels and transmission mechanisms, rather than the prediction of potential outcomes. Thus far SA has benefitted greatly from piggy backing off Chinas growth, who has in turn achieved their success through EU and US demand.

8.1. *Trade Flows*

Firstly, Direct impacts such as trade flows between China and SA are clear and easily measured. In trade, the relationship is mostly mutually beneficial as SA supplies the commodities China requires for growth and China provides SA with cheap consumer and capital goods (Kaplinsky et al., 2010) This being said, the relationship only remains complimentary if imported goods in SA do not crowd out SA industry, as it strives to move away from a primary good export position (Kaplinsky et al., 2010; Giovarnetti and Senfilippo, 2016). However, the composition of trade has changed over the last 10 years and SA has been exposed to greater risk as exports to China are now comprised mainly of raw materials (Ensor, 2014; Mhaka and Jeke, 2018) This has particularly impacted SA's manufacturing sector, which has had slow growth and high unemployment rates since its inception (DTI, 2010; Rodrik, 2008). Rapid growth in imports from China has been seen to contribute to the deindustrialisation of the economy, and forced it to remain as a primary commodity exporter (Maia, 2011). Therefore, imports from China may have affected the development of SA's manufacturing sector and increased imports may continue to do so. In addition, since SA is so reliant on China for export revenues, any decrease in demand for primary goods may negatively affect SA growth rates. Particularly, if the EU takes a strong stance alongside the US for more favourable trade agreements, there may be a decrease in demand for SA goods (Edwards and Jenkins, 2015). On the contrary an increase in demand for Chinas manufactured goods from the rest of the world could greatly enhance SA growth prospects, if it provides enough export revenue not just to service debts but to develop other industries. This is provided that the export revenues are high enough for SA to reduce its dependency on primary commodities. Indirectly, trade flows may have negatively impacted labour intensive industries in SA. However, Edwards and Jenkins (2015), find that imports from China tended to raise productivity within industries and contributed to lower producer price inflation therefore keeping consumer prices lower, as a result of efficiency gains. If the EU negotiates trade agreements that cause Chinas export prices to rise, it may create an opportunity for SA to develop manufacturing sectors to compete with these prices, as SA still has incredibly favourable trade deals with the EU. This outcome may give SA the chance to increase local production, specifically in industries of strength such as textile production.

8.2. *Financial Flows*

Secondly, changes in direct financial flows will impact SA greatly. Over 40% of daily trades in the JSE come from foreign investors, and SA is still relatively reliant on FDI. Sudden stops in capital will reflect negatively on the Current Account as well as in GDP growth. SA is susceptible to sudden stops in capital, as investment downgrades continue to threaten the stability of the economy in foreign eyes (World Bank, 2020). The SARB does not control the outflow of capital from JSE investments, meaning sudden stops are likely if SA is downgraded (Satander, 2018). Dependency on foreign investment, increases SA exposure to foreign shocks. If China struggles to maintain growth, or the EU is greatly impacted by Brexit, then over time reduced trade and investment would lead to the shrinking of the

SA economy (Summers, 2017). China has over 20 billion dollars' worth of investments in Africa, and signed 25 agreements with SA to the value on 16.5 billion dollars in 2015, in the hope of creating special economic zones. In addition, China pledged a 15 billion dollar investment to SA power utilities and infrastructure in 2018. A loss of momentum in Chinese investment in Africa would certainly hamper growth prospects. However, donations from the EU could easily offset these affects. Financial flows between China and the EU are limited by restrictions on cross-border financial transactions, investments and banking activities in China. Therefore slower Chinese growth is unlikely to impact the EU through the financial flows channel (European Commission, 2015). European Banks have relatively low direct exposure to China. However European financial markets do react significantly to negative news about Chinas economy and equity markets, leading to higher volatile in financial flows globally (European Commission, 2015). Emerging markets growth prospects have weakened leading to significant adjustments in exchange rates, credit markets and volatility levels, as these economies are exposed to capital flight and balance sheet exposure (World Bank, 2020). Slower Chinese growth could trigger a rise in corporate defaults, increasing deleveraging pressures and financial market volatility. The EU is exposed to these markets as they make up for almost 10% of EU foreign claims. Therefore, if other developing nations impacted negatively by problems in China there could be spill over effects affecting European banks.

8.3. The Commodity Price Channel

Thirdly, the commodity price channel presents a channel through which SA is exposed to the greatest risk and also has the potential to reap the greatest rewards. It is an important source of world demand particularly for metals and energy commodities, which represent a large composition of SA exports (European Commission, 2015). Indirect impacts of changes in external demand are felt in one dimension through global prices, as China is a large player in the price setting game. China's increased demand for commodities would raise global prices, which could impact SA negatively as a price taker in imports, such as oil, or positively in exports such as precious metals. Volatile commodity prices are as a result of changes in external demand. Between 2010 and 2015, Chinas decrease in demand for metals, let to a 33% decrease in iron ore prices (European Commission, 2015). If China's economy shifts from export-led growth to consumption-led growth, then metal commodity prices would decrease significantly. As China's slowdown sustains, SA's weak economic growth continues to get weaker, after the manufacturing and mining sector were negatively affected by dropping commodity prices in 2018 (World Bank, 2020). China's trade negotiations with SA indirectly impact its exposure to African trade agreements as SA is an influential economy in Africa. Overall, the nations have successfully realised the comprehensive strategic partnership envisaged in 2010 (Alden and Wu, 2014; Mhaka and Jeke, 2018). Lower commodity prices may lead to downward adjustments in the Rand as global capital flows adjust quickly to the changing environment. There is also potential for more abrupt adjustments in asset prices and global risk premia, if global outlook worsens significantly.

8.4. Exchange Rate Adjustments

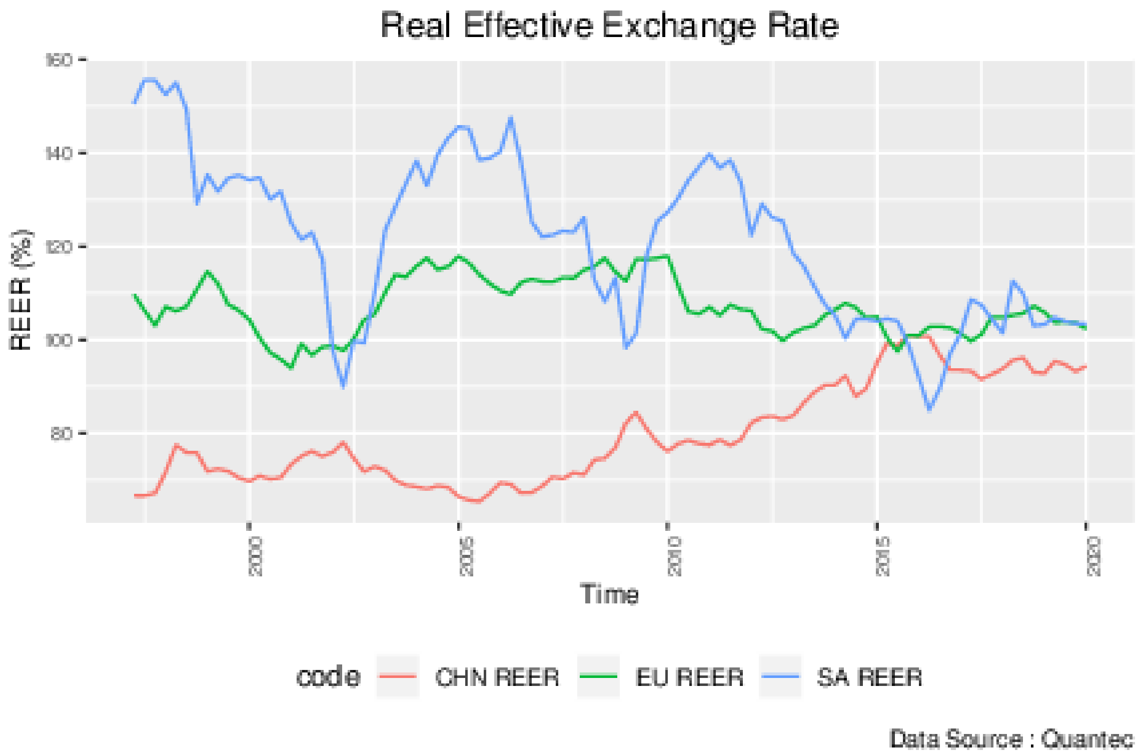

Figure 8.1: Real Effective Exchange Rate in China, SA and the EU

Lastly, exchange rate adjustment is an obvious consequence of interdependence. Weaker real exchange rates reduce imports and stimulate exports which leads to inflationary pressure, and in the SA case, usually is followed by adjustments from the SARB (Edwards and Lawrence, 2008). The South African Rand is traded on the “carry trade” which is a money market where foreign exchange brokers base their valuations on a countries economic strength and future prospects. Recently market sentiment suggest that the Rand is too weak to invest in. Exchange Rate adjustments which are caused partially by changes in trade demand, therefore have a spiralling affect, as trade demand reduces, the exchange rate devalues, investment drops and the cycle continues. That being said Mhaka and Jeke (2018), analyse the bilateral trade agreement between China and SA using a Gravity Model and determine that while exchange rate volatility impacts trade negatively, it has a limited contribution to trade changes. However, if emerging market currencies are placed under pressure from slow Chinese growth, then there is likely to be negative consequences for the euro. A slowdown in China could have limited direct effect on other economies in isolation however, the synchronisation of this effect across many smaller economies may lead to unexpectedly large adjustments. Asian economies are particular exposed to Chinas growth fluctuations which could affect the European financial system through indirect channels. A sharper-than-expected slowdown in China could therefore lead to an abrupt adjustment in global asset markets, as investor risk aversion increases and capital flows reduce.

9. Conclusion

Due to the scale and structure of the trade linkage between SA and China, any significant and negative adjustment in China's economic position is likely to negatively impact SA growth prospects. This exposure to China, could also serve as a benefit, as the linkages have historically led to South Africa piggy backing off China's success. Direct trade linkages make SA exposed export revenue fluctuations and import price fluctuations. Trade may be greatly affected indirectly, through trade with other emerging economies that have strong links to China. SA is also exposed to FDI and investment fluctuations from both China and the EU. Increased financial market volatility may arise as a result of negative spill overs into other emerging markets if China's slow down persists. The strongest impact, that changes in China-EU trade relations would have on SA, is through commodity price volatility. Commodity price volatility strongly impacts demand for SA's main export products, however lower commodity prices are beneficial for the European economy. If SA can reduce its dependence on commodity exports then EU demand for goods could offset the negative impact on commodity trade. This could also take place through the exchange rate adjustment channel as downward pressure on the rand leads to an appreciation of the Euro making SA exports more attractive.

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