
Trading with a Giant

The Implications of New
Zealand's Free Trade
Agreement with China

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ABSTRACT

This paper seeks to add to the literature on preferential trade agreements a deeper evaluation of the economy-wide impacts they can have. A relative novelty in the literature, the New Zealand-China case shows this from the perspective of a small economy that is somewhat isolated from markets and largely exports primary commodities. The more typical case concerns North-South PTAs, in which the developed partner is the larger economic power, which exports high value manufactured goods. We have found that, as well as those impacts of PTAs anticipated by scholarly writing on the subject, there are a number of implications that go beyond these. The FTA with China reveals vulnerabilities in New Zealand's growth model. The growth in demand for New Zealand's products from Chinese consumers following the FTA reveals a possible re-commoditisation of the country's production. This has the potential to push New Zealand further down the value chain.

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I Introduction

Preferential trade agreements (PTAs) can bring about many benefits to those who choose to engage in them. These include an increase in economic welfare, pacification of domestic lobbies and voters, and the cementing of political and diplomatic ties between signatories. The popularity of such accords is evidenced by their significant expansion seen particularly in the Asia-Pacific region. Indeed, they have increased from 8 concluded in 1998 to 60 by 2008, with the majority being free trade agreements (FTAs).¹ Based on a country's characteristics, however, the impacts of an FTA could be somewhat different to those typically expected. New Zealand is a small, highly liberalised economy, geographically distant from its major export markets, and has a comparative advantage in primary products. This makes it unusual compared with most OECD countries. In its trade relationship with China, which is economically and physically vastly larger, it imports high-value manufactured goods. This makes it atypical of North-South PTAs traditionally considered in scholarship on the subject. Considering these differences, this paper will explore what the FTA with China means for New Zealand, and what it can reveal about the economy going beyond the usual expected impacts. The paper will thus proceed as follows. First, it will outline the academic literature on the reasons behind countries' decisions to pursue PTAs. From this, we will derive a set of expected impacts on member countries. Second, it will present findings from a number of expert interviews with both government and non-government actors on their perceptions regarding the impacts of the FTA. Thirdly, it will build on the findings from the interviews that suggest there are implications that go beyond those found in the literature. The focus will thus shift to what the FTA with China reveals about the New Zealand economy. It will examine to what extent New Zealand is able to participate in global supply and value chains, and what the Government can do to facilitate this beyond the FTA.

II Literature Review

PTAs can be defined as “a set of institutions that are designed to foster economic integration among member-states by improving and stabilising each member's access to other participants' markets.”² Countries may seek this kind of integration in order to achieve economic welfare gains. This is

¹ Dent, C. M. (2010) 'Free trade agreements in the Asia-Pacific a decade on: evaluating the past, looking to the future,' *International Relations of the Asia-Pacific*, Vol. 10, No. 2, pp. 201 – 245

² Mansfield, E. D. and Milner, H. V. (2012) *Votes, vetoes, and the political economy of international trade agreements*. United States: Princeton University Press, p. 1

successful if the resulting trade between the two countries has a trade creating effect, rather than a trade diverting effect.³ That is, increased imports from the partner country contain lower costs of production than from a non-partner country. Other common potential benefits include securing stable export markets, as well as expanding foreign investment flows and creating greater income growth and job creation.⁴ The biggest beneficiaries are arguably consumers, who see their purchasing power increase, as well as greater competition and choice in products.⁵ A further welfare effect for governments is the elimination of “the classic terms-of-trade externality” that occurs under unilaterally set trade policy.⁶

The most typical impact is improved market access, with its attendant reduction in tariffs and non-tariff barriers (NTBs) such as reduced regulations.⁷ Investment promotion is facilitated through preferential market access, which makes the member country a more attractive investment location. Investment provisions within these agreements, which protect investors, can further spur investment.

PTAs can also have political impacts. They can help to overcome the sluggish pace of multilateral trade negotiations and achieve influential power over standard setting and rulemaking in trade and investment.⁸ Furthermore, PTAs can also serve as a foreign policy tool. This can be in order to cement ties with allies and to encourage partner countries to continue political and economic reform.⁹ The cementing of diplomatic ties through PTAs can also serve to forge new geopolitical alliances.¹⁰

Given that preference margins gained under PTAs can be very small, one rational theory proposed to explain why governments negotiate PTAs focuses on the need to reassure the public and domestic groups about their decision-

³ World Trade Organization (2011) *World Trade Report 2011: From Co-existence to Coherence*. Geneva: WTO, p. 100

⁴ Kim, H. C. (2011) ‘Dynamics of Free Trade Agreements: Benefits and Strategic Considerations,’ *SERI Quarterly*, July 2011.

⁵ *Ibid.*

⁶ *Ibid.*

⁷ Lynch, D. (2010) *Trade and Globalization: An Introduction to Regional Trade Agreements*. Plymouth: Rowman & Littlefield Publishers, Inc, p. 3-15.

⁸ Gómez-Mera, L. & Barrett, B. (2012) ‘Critical Debates – The Political Economy of Preferential Trade Agreements: Latin America and Beyond,’ *Latin American Politics and Society*, Vol. 54, No. 1.

⁹ Griswold, D. T. (2003) *Free-Trade Agreements: Steppingstones to a More Open World*. Trade Briefing Paper No. 18, Washington, DC: Cato Institute.

¹⁰ Crawford, J. and Fiorentino, R. V. (2005) *The Changing Landscape of Regional Trade Agreements*. World Trade Organization Discussion Paper No. 8, Geneva: WTO Publications, p. 16

making.¹¹ Particularly in democracies, governments are motivated to pursue trade cooperation in order to demonstrate to voters that they exercise sound economic management, which translates into votes at the polls. Trade agreements can be seen as an effective method to maintain the trust of voters because they act as a signal that the government will not unduly promote the demands of protectionist interests that could damage the economy.¹² That is, in order to resist the demands of domestic interests, PTAs can be used to commit a country's policy, and in a sense 'tie' the government's hands.

The Asia-Pacific region has seen a notable proliferation in PTAs. From containing only one major agreement before 2000 (the ASEAN FTA), the number of free trade agreement projects has exploded, to 107 by mid-2013, of which 75 had been signed or were already in force.¹³ Over 90 per cent of all the agreements concluded up to this point in the region have been bilateral.¹⁴ In this region and beyond, many of these PTAs have occurred between countries at unequal levels of development.¹⁵ The increasing frequency of asymmetric trade agreements between North and South has been explained in the context of the growing importance of investment flows from North to South since the 1990s.¹⁶ That is, the investment interests of multinational firms from capital exporting countries are behind the drive for PTA formation, rather than securing export markets. Moreover, the same author finds through case study analysis that the interests of a few industries or firms dominate negotiations, and that liberalisation often focuses on the goods in which these firms have an interest. This suggests that the expected outcome of a PTA at the national level would be an increase in investment from the partner country.

Another argument centres on the 'political domino effect' driven by governments' political-strategic goals. This posits that governments' main concern is to avoid exclusion "from a new dimension of regional economic diplomacy."¹⁷ Thus, the expectations of a PTA are less concerning economic gains, but rather the improvement of a country's reputation and position in the regional architecture.

¹¹ Mansfield, E. D. and Milner, H. V. (2012) *Votes, vetoes, and the political economy of international trade agreements*. United States: Princeton University Press, p. 8

¹² Chase, K. A. (2012) 'Edward D. Mansfield and Helen V. Milner. 2012. *Votes, Vetoes, and the Political Economy of International Trade Agreements* (Princeton, NJ: Princeton University Press)', *The Review of International Organizations*, Vol. 7, No. 4, pp. 449 - 452

¹³ Dent, C. M. (2013) 'Paths ahead for East Asia and Asia-Pacific regionalism,' *International Affairs*, Vol. 89, No. 4, pp. 963 – 985

¹⁴ Ibid.

¹⁵ Gómez-Mera, L. & Barrett, B. (2012) 'Critical Debates – The Political Economy of Preferential Trade Agreements: Latin America and Beyond,' *Latin American Politics and Society*, Vol. 54, No. 1

¹⁶ Manger, M. S. (2009) *Investing in Protection: The Politics of Preferential Trade Agreements Between North and South*. Cambridge, UK: Cambridge University Press, p. 1

¹⁷ Ibid.

From this, one would expect PTAs to deliver a number of benefits: stable export markets, welfare improvements, increased investment flows, greater trust in the government, improved political ties with the partner country, and greater regional influence. However, particularly regarding expectations around asymmetrical trade agreements, the New Zealand-China FTA does not correspond to the cases typically considered. Here, New Zealand is the developed economy, albeit one that is vastly smaller than the developing Chinese economy. Further to this, New Zealand is a particular case in that its exports are primarily concentrated in agriculture (mostly dairy) and forestry.¹⁸ This is somewhat unusual for an OECD, or 'northern', country, for which emerging markets such as China are more significant now than traditional markets such as the UK. Indeed, these emerging markets show significant demand for commodities (particularly for dairy) over consumer products and services.¹⁹ Thus, New Zealand in certain sectors bucks the trend of producing high value manufactured goods for export, and does not engage in a large amount of low-value production in developing countries. This would be in order to take advantage of cheaper production costs, especially labour costs, which in the Chinese case are rapidly rising.²⁰ Moreover, there are deeper economy-wide implications and impacts of the FTA that go beyond those outlined above, which we will explore below.

III The Evidence

The perception of the FTA has been mixed. Overall, it is not doubted that there has been a beneficial impact brought about by reductions in tariff barriers and greater trade with China. The diversion in perception comes with reflection on the extent to which market access has been brought about by the FTA. Non-tariff barriers (NTBs) and behind-the-border barriers remain significant. Utilisation of tariffs remains a challenge. Investment faces significant obstacles. The interviews for this study confirm the expectation above that the interests of multinationals (in this case, Fonterra and the dairy industry) are, if not a driving force of the FTA, at least seriously taken into consideration. Below we shall compare the government and non-government perceptions of the impacts the FTA has had.

¹⁸ New Zealand Trade and Enterprise (2014) *Statistics*. Available at: <https://www.nzte.govt.nz/en/invest/statistics/> (Accessed: 10 May 2015)

¹⁹ Ministry of Business, Innovation & Employment (2014) *The New Zealand Sectors Report 2014: An Analysis of the New Zealand Economy by Sector*. Wellington: MBIE, p. 16

²⁰ China Briefing (2014) *China's Rising Manufacturing Costs: Challenges and Opportunities - China Briefing News*. Available at: <http://www.china-briefing.com/news/2014/07/08/chinas-rising-manufacturing-costs-challenges-opportunities.html> (Accessed: 11 May 2015)

Government perceptions

Interviews with current and former government officials revealed an overall positive impression of both the outcomes and impact of the FTA, and the relationship between New Zealand and China more generally. As the fourth of the ‘series of firsts’ between China and New Zealand, New Zealand being the first OECD country to sign an FTA with China, the FTA was partially achieved through the recognition by New Zealand of China’s market economy status in the World Trade Organisation. The primary aim of the agreement had been to facilitate access and opportunities for New Zealand businesses. “Since 2008 it has been a case of following up on that, using the FTA as a platform for on-going discussion for finding ways to help New Zealand companies and highlighting problems.”²¹

Chinese demand for safe food has driven its need for greater trade with New Zealand. In the words of one senior public official, “China came to town and needed to be fed.”²² The FTA is also seen as a statement as to where China’s “strategic orientation” is, and that it has a “globalist outlook.”²³

For some, the FTA is a “game changer,” able to offer New Zealand “potentially unlimited demand.”²⁴ This gives New Zealand the confidence and freedom to decide how it wants to position itself in the world, and gives it confidence in its relevance.²⁵ At the technical level, it has been “amazingly successful” in “underpinning the relationship and outcomes.”²⁶ For businesses, the FTA has provided significant benefits and effectively put them on the Chinese radar. Chinese demand for New Zealand products has “exploded”²⁷ and trade is “through the roof.”²⁸ Firms need a “political and regulatory structure to make it as easy as possible to operate,”²⁹ which it is believed the FTA has aimed to achieve. Some of this trade, however, could be attributed to broader market reactions, rather than solely to the FTA. This can be demonstrated by the 2008 melamine crisis, which resulted in increased demand for New Zealand dairy products that were seen to be safer by Chinese consumers. Chinese demand for domestically produced dairy products, in particular milk powder, tumbled, leaving New Zealand to fill the gap with its reputation for high quality and trustworthy products. Indeed, the perception is that Fonterra and dairy have done particularly well out of the FTA and overall trade with China. This

²¹ Former Ambassador to China, Wellington, 4 March 2015

²² Senior public official, Wellington, 12 March 2015

²³ Former Ambassador to China, Auckland, 9 March 2015

²⁴ Ibid.

²⁵ Ibid.

²⁶ Senior public official, Wellington, 12 March 2015

²⁷ Senior public official, Wellington, 12 March 2015

²⁸ Senior public official, Wellington, 11 March 2015

²⁹ Former Ambassador to China, Wellington, 4 March 2015

company also demonstrates the Government view, that investment follows trade. The “strategic messaging,”³⁰ it is claimed, makes a difference to Fonterra in terms of market access, commitments and protections.

Another example of a sector that has benefited from the FTA is seafood, in particular lobster. Before the implementation of the FTA, these were sold to middlemen in Hong Kong and then transferred “in the dead of night” by boat to Guangzhou, where a bribe would be paid to get them into China. According to the interviewee, “the whole New Zealand lobster industry was dependent on the smuggling route staying open.”³¹ The FTA brought in tariff reductions, which meant it became economical to ship through conventional channels at a price no greater than that incurred through the unconventional, smuggling route. That is, the FTA regularised and protected goods going to China. In addition, there was therefore a tariff advantage over Australia and South Africa, who still had to use the “grey channel.”³² This is an example of the much-touted ‘first mover advantage.’

Despite the above, government representatives have recognised that there are certain limitations in the trade relationship. These are regulatory in nature and include required documentation such as certificates of origin and certification of non-manipulation. Because of the way many goods are shipped, they cannot obtain the documentation, and therefore cannot benefit from the preferential tariff.³³

Non-government perceptions

The view from business, associations, academia and the media present a much more convoluted view of the impact of the FTA, with both strong positive and negative reactions to it. On the positive side, interviewees cited the huge growth in post-FTA trade, especially in 2013. A number of them stated that the FTA has been good for their individual businesses in different sectors. In addition to the reduction in tariffs, which for some meant a decrease from 20 per cent to zero per cent and thus a markedly lower cost of doing business, the FTA has achieved knowledge of New Zealand and its companies among Chinese customers and businesses. This allowed firms to build relationships at the time of the FTA, which they claim is essential to succeeding in China. Moreover, due to the FTA, Chinese business considers dealing with New Zealand as less of a risk, providing New Zealand firms with an “extra card to play in getting business.”³⁴

³⁰ Senior public official, Wellington, 12 March 2015

³¹ Former Ambassador to China, Wellington, 4 March 2015

³² Ibid.

³³ Senior public official, Wellington, 12 March 2015

³⁴ Head of Asia Department, Auckland, 17 February 2015

The FTA is seen as signifying on-going engagement with China and as having accelerated the relationship between the two countries, even if it would have been significant for New Zealand regardless of the FTA. In dairy, it was noted that at their peak, exports to China grew to over 1 million tonnes. Dairy is also a special case concerning non-tariff barriers, which one business owner noted did not experience any problems with these as it might in other markets, “because [the Chinese] want our products.”³⁵ Moreover, while there might have been some “challenges” around tariffs on dairy, it is recognised that this is simply in the nature of such negotiations.

Benefits were also perceived to be indirect. Given the “good history of firsts”³⁶ between New Zealand and China, one firm was able to get a proposed venture on President Xi’s agenda during his visit to New Zealand. This resulted in the deal going through much faster. The success of the venture demonstrates an indirect economic effect that is brought about through the political relationship between the signatory countries, going beyond the literature discussed above. That is, interpreting the greater effect of the FTA to be a symbol confirming the political relationship needs to go further, by recognising the resulting facilitation of business and trade.

However, negative perceptions of the impacts of the FTA were prevalent. It was perceived by some to be “disappointing.”³⁷ NTBs such as safeguards have frequently been triggered. Various certification requirements have created many headaches and prevented the ability of New Zealand exporters to take advantage of preferential rates, or even get their products over the Chinese border. “These certificates aren’t even available for air shipment and trans-shipped goods, which means a lot of goods are excluded from the Chinese market.”³⁸ Certificates of non-manipulation are required by Chinese authorities for goods that go through a third country, to prove that the good has not been manipulated in any way. If it has, the tariff changes on the good. These certificates are only issued by Singapore and Hong Kong, meaning that if a good is shipped to China through Australia, it cannot obtain this certificate, and therefore cannot benefit from the preferential tariff. Moreover, some important commodity exports, such as logs, wood and other forestry products, did not receive any concessions, despite being the third most important commodity export. This suggests preference margins in this and other sectors may not be as high as one might expect under a FTA.

³⁵ CEO, telephone interview, 9 March 2015

³⁶ Chief of Strategy employee, Auckland, 26 February 2015

³⁷ Executive Director, Auckland, 17 February 2015

³⁸ Ibid.

In terms of its impact on business decisions, the FTA appears to have been a minimal factor. Indeed, some businesses had gone to China *despite* the FTA. A greater factor appeared to be the growth of the middle class. The demand for infant formula demonstrates this growth, with 500,000 to 600,000 tonnes being exported to China annually, out of a total annual production of 2.8-3 million tonnes. Under the FTA, however, only the first 120,000 tonnes receive the preferential tariff. The rest comes under the most favoured nation (MFN) tariff.³⁹

Businesses and other actors also commented on the political impacts of the FTA, such as the ability of New Zealand to thereby “secure its relevance.”⁴⁰ One interviewee noted that in China, Prime Minister Key appeared to be particularly highly regarded, and that he “punches above his weight...he definitely has hero status in China.”⁴¹ Another perhaps unforeseen impact mentioned was the potential side effect of China’s choosing New Zealand as its first FTA partner. That is, in the words of one interviewee, “China has basically chosen New Zealand as the soft underbelly of the West, using New Zealand to secure arrangements to pressure other countries.”⁴² By recognising China’s Market Economy Status, New Zealand had effectively “skipped its place in the queue” by giving away this negotiating position. This might undermine the negotiation stance of other countries, and turn out to be self-serving for New Zealand.

The perceived impacts by both government and non-government actors thus confirm a number of the expected impacts outlined at the beginning of this paper. It appears that the FTA has indeed cemented diplomatic and political ties between New Zealand and China. Further, both government and non-government actors recognise the function of securing New Zealand’s relevance in the regional order. A tangible welfare effect can also be gleaned from the increase in trade and investment flows, although this is tempered by the experience of many firms of products that are unable to take advantage of the preferential tariffs. It has nonetheless delivered a relatively stable export market. Consumers’ purchasing power has undoubtedly increased, given the expansion of imports in manufactured goods since the implementation of the agreement. The FTA has also potentially increased New Zealand’s geopolitical clout, given the perception highlighted by one of the interviews that Prime Minister Key carries great weight in China. Through this connection with China, and the negotiation of other agreements in the Asia-Pacific region highlighted above, New Zealand can increase its influence.

³⁹ Senior Manager, Auckland, 25 February 2015

⁴⁰ Journalist, Auckland, 15 March 2015

⁴¹ CEO, telephone interview, 9 April 2015

⁴² Director, telephone interview, 13 March 2015

However, there are a number of impacts that are not included in those predicted above. These include the regularisation and protection of goods being exported to China, as demonstrated by the example of lobster. In addition, not enough is made of the political impact that the FTA signals, leading to an indirect economic effect. This is demonstrated by the example of the business that was able to make President Xi aware of a deal during a state visit, which facilitated the time-efficient conclusion of that deal. There thus appears to be much more to be learnt from the New Zealand-China FTA case, particularly relating to the New Zealand economy. As mentioned above, the reversed North-South asymmetry between New Zealand and China makes it an unusual case. We will therefore explore the implications of this asymmetrical trading relationship that go beyond the expected impacts we have examined so far. This will include perspectives on a possible dependence of New Zealand on China, as well as the extent to which New Zealand can be effectively integrated into global value chains.

IV Further Implications

Let us thus turn to the first of these implications: the possible dependence on China. Its status as New Zealand's number one trading partner, as well as that of New Zealand's other trading partners, leaves New Zealand potentially doubly exposed to any collapse in Chinese demand or diminished market access. According to one CEO, "A smart strategist wants eggs in lots of baskets, but at the moment the Chinese are paying more than anywhere else."⁴³ Another senior employee at a major bank said he did not "know what New Zealand would look like without China."⁴⁴ To some, the dependence risk was less around a potential slowdown in the Chinese economy than barrier issues at the border for New Zealand products, and changes in regulations. Nevertheless, others did not feel that New Zealand as a whole, nor individual companies, were overly exposed to the Chinese economy. Some compared the Chinese situation with the previous situation New Zealand had experienced with the UK. Compared to the 60 per cent of non-transformed goods being exported to the UK,⁴⁵ the 22 per cent currently going to China did not present an issue.

The more troublesome element regarding dependence was the concentration of goods in New Zealand's export product mix. "We have to take the opportunities where they are," in the words of one academic.⁴⁶ However, one stream of thought posits that commodity-exporting countries are particularly

⁴³ CEO, Auckland, 19 February 2015

⁴⁴ Head of department, Auckland, 17 February 2015

⁴⁵ Chief Executive, Auckland, 23 February 2015

⁴⁶ Academic, Wellington, 3 March 2015

vulnerable to demand and price changes, and would benefit from diversifying their export bases.^{47,48} UNCTAD's export concentration indices show that New Zealand has an index of 0.17, signalling a relatively high concentration of exports compared with the OECD median of 0.12. Moreover, the small size of the economy "limits economies of scale and prevents large-scale industries developing, and our isolated location presents another headwind in that we face relatively high transport costs for our goods."⁴⁹ We will see further below that these are two major factors limiting New Zealand's participation in global value chains.

Trade Minister Hon Tim Groser has also recognised the danger of 'indirect dependency', especially through what he calls the "triangulation of the NZ-Australia-China economic relationship."⁵⁰ With the New Zealand economy relying to such an extent on both the Chinese and Australian economies, there are concerns that Australia's economy is even more exposed, with an even narrower product base, than New Zealand. Therefore, any negative impact on the Australian economy through a reduction in Chinese demand for its mineral exports will also negatively impact the New Zealand economy. This is also the case for any other trade partners.

Hon Phil Goff, who signed the FTA on behalf of New Zealand in 2008, has echoed the indirect and direct effect of any slow-down in trade with China. However, in his view, demand for soft commodities like dairy and others produced by New Zealand is not likely to change any time soon. The only problem might be the tarnishing of the "100 per cent pure New Zealand" brand through the above-mentioned food scares in the dairy sector.⁵¹

Nonetheless, there are countries that export more products to China than New Zealand. One senior public official pointed out that previous experiences had taught companies how to "move when necessary, and quite quickly,"⁵² implying that if demand were to slow down for any reason, companies would have the necessary agility to shift to more promising markets. Furthermore, demand from China is unlikely to decrease, given the on-going rebalancing of

⁴⁷ Janson, M. (2004) *Income volatility in small and developing economies: export concentration matters*. Geneva: World Trade Organisation

⁴⁸ New Zealand Treasury (2014) 'Special Topic: Should we worry about New Zealand's trade concentration?' *Monthly Economic Indicators March 2014*. Wellington: New Zealand Treasury

⁴⁹ Ibid.

⁵⁰ Groser, T. (2014) 'China – Trading Up or Creating Dependency ?' in Harris, P. (ed.) *China at the Crossroads: What the Third Plenum Means for China, New Zealand and the World*. Wellington, New Zealand: Victoria University Press, p. 20

⁵¹ Goff, P. (2014) 'A Changing China – Implications for New Zealand,' in Harris, P. (ed.) *China at the Crossroads: What the Third Plenum Means for China, New Zealand and the World*. Wellington, New Zealand: Victoria University Press, p. 29

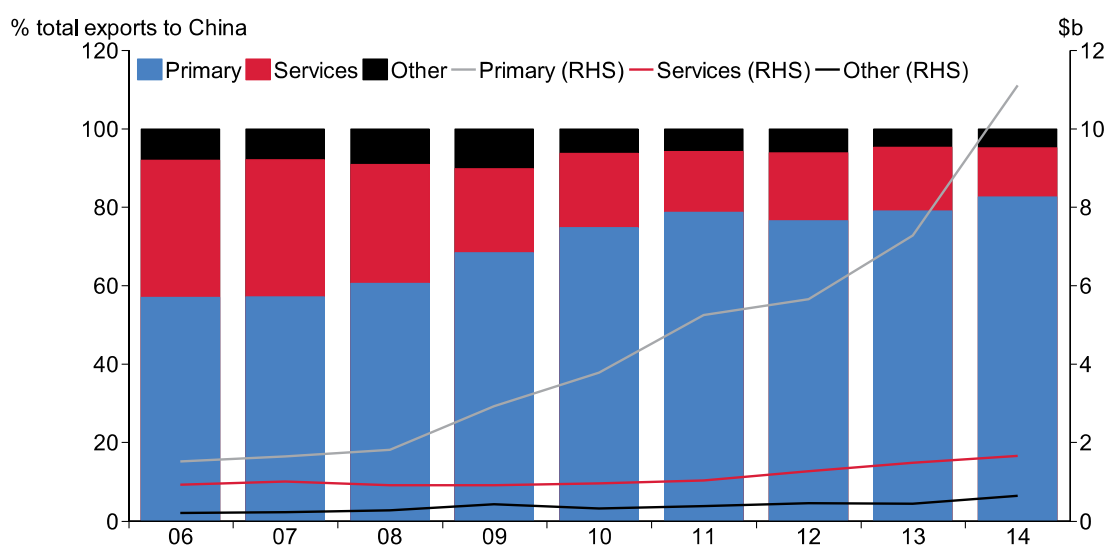
⁵² Senior public official, Auckland, 25 February 2015

its economy towards consumption.⁵³ This, according to the Treasury, means that New Zealand is well placed in its comparative advantage in “soft commodities” to fulfil the demand for more dairy and protein. It is “likely to translate into a stable and dependable source of export demand in the future.”⁵⁴

A somewhat more positive implication of the arguable dependence on China is the effect on New Zealand’s terms of trade. The Reserve Bank of New Zealand asserts that this is the most significant economic linkage to China. These terms of trade have seen a notable increase in the last 15 years, in no small part due to China’s impact on higher export prices and lower import prices.⁵⁵

However, concerns around the implications of insatiable Chinese demand for New Zealand’s soft commodities extend also to New Zealand’s environment, as well as its product mix. For example, primary exports – including dairy, forestry and meat – have increased by 80 per cent since 2008.⁵⁶ The graphic below offers a visual representation of the magnitude of primary exports.

Figure 1: Composition of New Zealand Exports to China (annual)



Source: Kendall, R. (2014) *Economic linkages between New Zealand and China*. Analytical Note No. 6, Wellington: Reserve Bank of New Zealand, p. 7

Dairy in particular has shown significant growth, overshadowing other primary exports by a notable margin. Within dairy, furthermore, whole milk

⁵³ New Zealand Treasury (2014) ‘Special Topic: Should we worry about New Zealand’s trade concentration?’ *Monthly Economic Indicators March 2014*. Wellington: New Zealand Treasury

⁵⁴ Ibid.

⁵⁵ Kendall, R. (2014) *Economic linkages between New Zealand and China*. Analytical Note No. 6, Wellington: Reserve Bank of New Zealand, p. 2

⁵⁶ Ibid., p. 6

powder dominates.⁵⁷ Meat exports to China have increased by more than NZ\$1 billion over the last five years,⁵⁸ and exports of beef have increased by 374 per cent to the year 2013.⁵⁹ Sir Graeme Harrison, Chairman of ANZCO Foods, has noted that under projections of the FAO, global demand for meat will exceed dairy in comparative terms.⁶⁰ He sees significant potential for beef production to add to New Zealand export earnings. New Zealand, moreover, has a “gold medal” opportunity to “boost its primary industries potential at a speed never experienced in our history.”⁶¹

However, another longer-term implication of the increased demand and profitability of commodity production is that ever more land is being converted for use in dairy and beef production. There is no sign of demand for these products slowing down. One senior public official said, “There have been big shifts in land use to provide dairy products to China... We are an island and have reached the limit of our landscape,”⁶² while another identified the challenge to New Zealand that “we don’t have endless resources.”⁶³ Land that had previously been considered unsuitable for dairy farming was now being used for this purpose, with large-scale irrigation employed to overcome this. By one official’s estimations, New Zealand’s physical landmass could feed only 30 to 50 million people.⁶⁴ Andrew Cornell of ANZ has noted that dairy intensification in New Zealand leads to concerns that effluent run off and land degradation could damage the country’s “100 per cent Pure” brand.⁶⁵ The senior official said that therefore in order to grow, companies must expand internationally. They can achieve this either by selling commodities, which face environmental constraints, or by “going up the value chain, which is our only path.”⁶⁶

Growing Chinese demand for New Zealand’s soft commodities could have a worrying impact on the New Zealand economy: the re-commoditisation of production. While most OECD countries have a comparative advantage in

⁵⁷ Kendall, R. (2014) *Economic linkages between New Zealand and China*. Analytical Note No. 6, Wellington: Reserve Bank of New Zealand, p. 7

⁵⁸ Fulton, T. (2015) ‘The big China trade-off’, 28 February [Online] Available at: <http://www.stuff.co.nz/business/farming/dairy/66775124/The-big-China-trade-off> (Accessed 31 March 2015)

⁵⁹ Groser, T. (2014) ‘China – Trading Up or Creating Dependency?’ in Harris, P. (ed.) *China at the Crossroads: What the Third Plenum Means for China, New Zealand and the World*. Wellington, New Zealand: Victoria University Press, p. 24

⁶⁰ Harrison, G. (2013) ‘Address by Graeme Harrison, Chairman, ANZCO Foods Limited’, China Business Summit, Auckland, 16 October.

⁶¹ Ibid.

⁶² Senior public official, Wellington, 12 March 2015

⁶³ Senior public official, Wellington, 12 March 2015

⁶⁴ Senior public official, Wellington, 12 March 2015

⁶⁵ Cornell, A. (2014) ‘New Zealand’s Bull – or Cow – Rush.’ Available at: <https://bluenotes.anz.com/posts/2014/06/new-zealands-bull-or-cow-rush/> (Accessed 25 May 2015)

⁶⁶ Senior public official, Wellington, 12 March 2015

services and manufactured goods, New Zealand faces the risk of being forced further down the value chain if it exports mostly low value components that are further processed abroad. Milk powder is an example of this. In order to ensure a diversification of the export product base and the presence of incentives for innovation, New Zealand must promote efforts to move up the value chain. In order for this to happen, New Zealand must become better integrated into global value chains (GVCs).

Pursuing this objective means that countries such as New Zealand try to 'upgrade', in which they follow strategies for the improvement or maintenance of their position in the global economy.⁶⁷ The challenge, Gereffi notes, is for countries and firms to "climb the value chain' from basic assembly activities using low-cost and unskilled labour to more advanced forms of 'full package' supply and integrated manufacturing."⁶⁸ In New Zealand's case, increased trade with China – arguably as a result of the FTA – means producers have significant opportunities to supply intermediate goods to the Chinese food-processing sector.⁶⁹ This raises the concern that New Zealand might be 'downgrading' through its trade with China.

The high level of concentration in trade with China also exposes New Zealand to risks associated with the asymmetry in economic size. That is, as the much smaller partner in the trade relationship, the Treasury is concerned that New Zealand exporters' ability to move up the value chain in later years will be limited.⁷⁰ Moreover, as the trade relationship continues to grow, there is a chance that trade will increasingly be on China's terms as the buyer, rather than on New Zealand's terms as the seller.⁷¹ This means New Zealand would be exposed to a more Chinese controlled buyer driven production network.⁷²

Data from the OECD-WTO *Trade in Value Added* database suggests that New Zealand has low trade intensity by international standards, as well as limited overall participation in GVCs.⁷³ The highest value is typically created in upstream activities, such as R&D and product design, or downstream

⁶⁷ Gereffi, G. (2014) 'Global value chains in a post-Washington Consensus world,' *Review of International Political Economy*, Vol. 21, No. 1, pp. 9 - 37

⁶⁸ Ibid.

⁶⁹ Stringer, C. (2014) 'Christina Stringer says there is an urgent need for New Zealand companies to upgrade their GVCs to avoid becoming little more than Chinese cost centres,' 23 September [Online] Available at: <http://www.interest.co.nz/business/72103/christina-stringer-says-there-urgent-need-new-zealand-companies-upgrade-their-gvcs-av> (Accessed 23 April 2015)

⁷⁰ New Zealand Treasury (2014) 'Special Topic: Should we worry about New Zealand's trade concentration?' *Monthly Economic Indicators March 2014*. Wellington: New Zealand Treasury

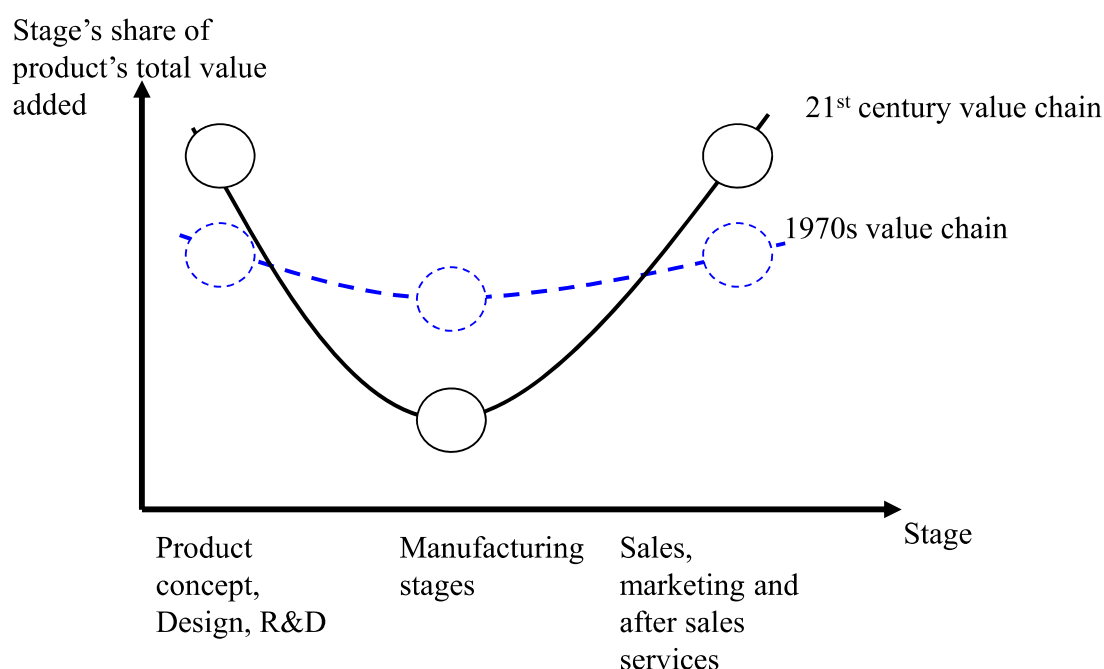
⁷¹ Ibid.

⁷² Gereffi, G. and Lee, J. (2012) 'Why the World Suddenly Cares About Global Supply Chains', *Journal of Supply Chain Management*, Vol. 48, No. 3

⁷³ OECD (2013) *OECD Economic Survey: New Zealand 2013*. Paris: OECD, p. 61

activities in marketing and branding.⁷⁴ This is demonstrated in the figure below. New Zealand’s geographical isolation partially explains the low ratio of imports contained in its exports, in addition to its relatively high dependency on agricultural exports, which also have a low foreign content.⁷⁵ Further, McKinsey’s Global Institute Connectedness Index ranks New Zealand 43rd out of 131 countries.⁷⁶ According to their report, the strong focus on China may mean New Zealand is missing growth opportunities in other emerging markets in the Asian region. Knowledge-intensive flows from New Zealand are also lagging far behind other major economies.⁷⁷

Figure 2: The smile curve – good and bad stages in the value chain



Source: Baldwin, R. (2012) ‘Global Supply Chains: Why They Emerged, Why They Matter, and Where They Are Going,’ *Discussion Paper No. 9103*, London: Centre for Economic Policy Research

The above figure suggests that it is the service component of production and trade that is most significant in incorporating firms into value-added activities.

A number of those interviewed noted the difficulty for New Zealand in linking to GVCs. “It is a long way from markets and consumers.”⁷⁸ Another mentioned

⁷⁴ Ibid.

⁷⁵ Ahmad, N. (2013) ‘Estimating trade in value added: why and how?’ in Elms, D. K. and Low, P. (eds.) *Global Value Chains in a Changing World*. Geneva: WTO, p. 91

⁷⁶ McKinsey & Company (2015) *Companions Abroad: Australia and New Zealand’s participation in global flows*. [Online] Available at: http://www.mckinsey.com/~media/McKinsey%20Offices/Australia/PDFs/Companions_Abroad-Australia_and_New_Zealands_participation_in_global_flows.ashx (Accessed 14 May 2015)

⁷⁷ Ibid.

⁷⁸ Chief Executive, Auckland, 17 February 2015

the “tiny” size of the country, and so questioned, “Why would anyone invest here?”⁷⁹ Indeed, in order to firm up their position in the value chain, there was general consensus that it was imperative for New Zealand companies to add value to their production. However, it was mostly large companies such as Fonterra that have been able to overcome the issues of scale and access to capital that plague smaller players. It has internationalised and succeeded in closing the geographical gaps to key markets. Smaller firms make up the majority of the economy; despite this, these firms are hindered in their ability to do the same. Companies that manage to offshore production and distribution processes “[level] the playing field with foreign rivals” regarding costs and speed to market, according to an OECD study. Furthermore, “speed to market” could “shift the basis of competition towards higher value-added activities such as R&D, branding and design.”⁸⁰ Access to capital is therefore essential to this endeavour.

In New Zealand, “capital is thin on the ground.”⁸¹ Therefore, attracting foreign investment is necessary to overcome a lack of domestic capital. However, “the issue is that there aren’t enough big companies to invest in.”⁸² Large foreign investors typically look to invest sums of \$20 - \$500 million, however most New Zealand companies are looking for much more modest amounts, usually around \$5 million. Of the approximately 13,000 companies exporting out of New Zealand, only 240 of these reported more than \$25,000 export revenue. This was simply too small to attract the majority of foreign investors.⁸³ In the experience of an employee at one of New Zealand’s largest banks, even for those companies seeking to invest offshore into China, the majority simply did not have the scale to do so. They were not able to find equity to fund such an expansion.⁸⁴ “We need another five Fonterras.”⁸⁵

However, increased trade with China and its pursuit of security of supply and safe products provides the opportunity for the gap in availability of New Zealand domestic capital to be filled by Chinese investors. There are nonetheless concerns also about such Chinese investment, particularly in productive agricultural land.⁸⁶ “Some Chinese investors want farms, some want processing facilities. The aim is to get further down the supply chain.”⁸⁷

⁷⁹ Senior public official, Wellington, 12 March 2015

⁸⁰ OECD (2013) *OECD Economic Survey: New Zealand 2013*. Paris: OECD, p. 62

⁸¹ Executive Director, Auckland, 18 February 2015

⁸² Senior public official, Wellington, 12 March 2015

⁸³ Ibid.

⁸⁴ Head of department, Auckland, 17 February 2015

⁸⁵ Senior public official, Wellington, 12 March 2015

⁸⁶ Fox, A. (2015) ‘Train wreck remodelled as award-winner’, *The New Zealand Herald*, 17 April

[Online] Available at: <http://www.stuff.co.nz/business/farming/dairy/67648645/Train-wreck-remodelled-as-award-winner> (Accessed 26 May 2015)

⁸⁷ Chief Executive, Auckland, 18 February 2015

There is a potentially somewhat racist element to calls for the limitation on Chinese investment by the New Zealand public, which rears its head whenever a new foreign investor begins commanding a presence in the country.⁸⁸ On the debate around the current level of Asian investment in New Zealand, a senior Government advisor affirmed, “it is very politicised, and tends to come up around election time.”⁸⁹ However, limiting Chinese investment could be seen as a case of New Zealand shooting itself in the foot, and is not something the Government appears to be doing. Changing investment rules to allow for popular sentiment and the political cycle would damage New Zealand’s prospects as an investment destination, with the risk that it could be seen as “fickle in its approach to foreign investment,” according to prominent lawyer Cathy Quinn.⁹⁰

As well as increased foreign investment, we have seen that adding value is crucial to New Zealand’s long-term growth. New Zealand has a high ratio of domestic value added to its gross exports. Unlike most economies, however, this is not due to the presence of a large economy that enjoys a greater range of domestic suppliers. In New Zealand’s case, the high ratio of domestic value added is due to it being an exporter of natural resources; with therefore less complex supply chains.⁹¹

Auckland University Professor Christina Stringer emphasises the importance of companies’ efforts to upgrade their GVCs, otherwise they may “become little more than a Chinese cost centre.”⁹² It is imperative, in her view, that companies understand their position within GVCs, so that they can maximise value and move into “higher value added segments of China’s value chains.”⁹³ Broadly, interviewees for this study acknowledged the need for New Zealand’s product mix to move towards niche, value-added products. Food and beverage, important to New Zealand’s export basket, needed to move up the value chain, and an expansion in specialised manufactured goods would be welcome.⁹⁴ These were science and knowledge intensive activities. Further,

⁸⁸ Quinn, C. (2015) *Chinese Investment in New Zealand – should New Zealanders be fearful?* 16 April [Online] Available at: http://www.minterellison.co.nz/Chinese_Investment_in_New_Zealand/ (Accessed 26 May 2015)

⁸⁹ Senior public official, Wellington, 12 March 2015

⁹⁰ Quinn, C. (2015) *Chinese Investment in New Zealand – should New Zealanders be fearful?* 16 April [Online] Available at: http://www.minterellison.co.nz/Chinese_Investment_in_New_Zealand/ (Accessed 26 May 2015)

⁹¹ New Zealand Treasury (2014) *Holding on and Letting Go: Opportunities and challenges for New Zealand’s economic performance - A perspective from the Treasury*. Wellington: New Zealand

⁹² Stringer, C. (2014) ‘Christina Stringer says there is an urgent need for New Zealand companies to upgrade their GVCs to avoid becoming little more than Chinese cost centres,’ 23 September [Online] Available at: <http://www.interest.co.nz/business/72103/christina-stringer-says-there-urgent-need-new-zealand-companies-upgrade-their-gvcs-av> (Accessed 23 April 2015)

⁹³ Ibid.

⁹⁴ Senior public official, Wellington, 12 March 2015

the New Zealand Government has in place measures to deter producers engaging in low value production and environmental degradation. These include putting a price on environmental non-performance, paying for water and applying limits to nutrient leeching, in order to increase costs of production. Other measures to encourage higher value added activities include R&D rebates and funds to develop markets for value-added.⁹⁵ Commoditisation is discouraged through, for example, the ‘Sustainable Dairying: Water Accord’ between the Government and some of New Zealand’s key dairy companies.⁹⁶

However, the open nature of the New Zealand economy means that businesses respond to the market. The trade with China demonstrates, through New Zealand’s export mix, that low-value intermediate goods and commodities are being demanded, which limits efforts to “promote an increasing move up the value-added curve,”⁹⁷ in the words of one interlocutor. In his arguably optimistic view, New Zealand will hit its supply limits in 20 to 30 years’ time, and will then “move up the high value curve like Switzerland and the EU has done.”⁹⁸ Nevertheless, for the meat sector, Chinese demand from the growing middle class could also provide an opportunity. Murray Brown of the Alliance Group, another meat exporter, sees chilled meat as the “next potential growth surge in trade in China.” The opportunity for higher value is that chilled meat commands a higher premium price than frozen meat, the latter of which currently dominates meat exports to China. In Brown’s view, “the evolution of the middle class means that sophisticated and seasoned shoppers – those able and willing to pay a premium for quality – will soon emerge as the dominant force.”⁹⁹

Whether the FTA has helped New Zealand firms integrate into GVCs is another matter. The nature of FTAs is to discriminate against non-members, and their proliferation has created a ‘spaghetti bowl’ of overlapping and bureaucratic trade procedures.¹⁰⁰ These contradict the fundamental logic of GVCs, which are meant to “expand seamlessly across borders.”¹⁰¹ They may nonetheless facilitate participation if they remove non-tariff measures such as technical

⁹⁵ Ibid.

⁹⁶ Dairy NZ (2013) ‘Sustainable Dairying: Water Accord’ [Online] Available at: <http://www.dairynz.co.nz/what-we-do/advocacy-and-policy/environment/sustainable-dairying-water-accord/> (Accessed 26 May 2015)

⁹⁷ Former Ambassador to China, Auckland, 9 March 2015

⁹⁸ Ibid.

⁹⁹ Tan, Y. H. (2014) *Counting sheep to China*. 24 November [Online] Available at: <http://www.maersk.com/en/the-maersk-group/about-us/maersk-post/2014-5/counting-sheep-to-china> (Accessed 4 April 2015)

¹⁰⁰ Razeen, S. (2013) ‘Global value chains, trade policy, and Asia,’ 13 June [Online] Available at: <http://www.eastasiaforum.org/2013/06/13/global-value-chains-trade-policy-and-asia/> (Accessed 4 May 2015)

¹⁰¹ Ibid.

regulations, complex rules of origin, and restrictive trade-related financial and investment regulations.¹⁰² However, FTAs mostly do not deal with the regulatory barriers that firms face in GVCs.¹⁰³ As we have seen above, this also applies in the case of the New Zealand-China FTA. Nevertheless, the FTA has helped to the extent that it is incrementally bringing down tariff barriers in China. That is, by reducing trade costs the FTA could, in theory, help integrate firms into global supply and value chains.¹⁰⁴ In addition, the investment chapter has the potential to create a more predictable and secure investment environment between the two countries, promoting an increase in flows to New Zealand.

Smaller players have been undertaking efforts to move up the value chain through partnerships with Chinese companies. Whether this investment by Chinese companies has come about as a result of the FTA is not clear, although the agreement may have acted as a facilitating factor. Nonetheless, in the infant formula industry, Synlait has effectively closed the geographical gap to its market in China through investment by Bright Dairy and outbound investment into New Hope Nutritional Foods. The latter firm imports canned infant formula for one of its brands, then promotes and distributes this in China. A significant benefit of this partnership is its conformance with the Chinese government's drive to ensure supply chain integrity and linking of the brand all the way back to the source of the product in New Zealand, which is something Chinese consumers also demand.

Carrickmore Nutrition, another infant formula company, has established distribution networks with Gentech Food, a Chinese firm based in Guangzhou and Shanghai.¹⁰⁵ Fonterra is also pursuing opportunities in infant formula, with its recent acquisition of 18.8 per cent of Chinese infant formula manufacturer Beingmate, worth NZ\$755 million. However, the former New Zealand Reserve Bank governor Alan Bollard has pointed to research by Coriolis, a consultancy, on the infant formula value chain, which suggests that only 10 per cent of the end consumer price is captured by New Zealand dairy farmers or processors.¹⁰⁶ Companies such as Carrickmore Nutrition,

¹⁰² Nicita, A., Ognivtsev, V. and Shirotori, M. (2013) *Global Supply Chains: Trade and Economic Policies for Developing Countries*. Geneva: UNCTAD, p. 13

¹⁰³ Razeen, S. (2013) 'Global value chains, trade policy, and Asia,' 13 June [Online] Available at: <http://www.eastasiaforum.org/2013/06/13/global-value-chains-trade-policy-and-asia/> (Accessed 4 May 2015)

¹⁰⁴ Nicita, A., Ognivtsev, V. and Shirotori, M. (2013) *Global Supply Chains: Trade and Economic Policies for Developing Countries*. Geneva: UNCTAD, p. 2

¹⁰⁵ Stewart, T. (2012) 'NZ formula finds lucrative Chinese market' 12 July [Online] Available at: <http://www.stuff.co.nz/business/industries/7263884/NZ-formula-finds-lucrative-Chinese-market> (Accessed 31 March 2015)

¹⁰⁶ Fallow, B. (2015) 'NZ too low on value chain: Bollard', *The New Zealand Herald*, 21 March [Online] Available at: http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11420691 (Accessed 21 March 2015)

Goodman Fielder and Synlait are among a number that partner with Chinese firms in order to access privileged distribution networks, through which they can “get to places in China that no one else can.”¹⁰⁷ Tatua has managed to climb the value chain through its production of high value niche products that command a premium price. Its success rests on its rapid adaptability to market dynamics.¹⁰⁸

An important access point for selling such high value products and overcoming scale limitations and capital constraints is the recent explosion in e-commerce. The Alibaba Group has created an online platform called *Tmall*, which is China’s most widely used Internet commerce platform for selling Chinese and international brands directly to Chinese consumers.¹⁰⁹ For example, in infant formula, with its particularly complex supply chain, the online platform “cuts straight through” inefficiencies in the supply chain with China.¹¹⁰ Without a proper strategy, however, firms would not be able to “capture customers who are spoiled for choice.”¹¹¹

Preferential trade agreements can thus bring many advantages, both economic and political, to those who engage in them. The literature on PTAs, however, does not go into their implementation, and how countries can make the most of them. If New Zealand is to be able to gain more of the expected benefits outlined in the literature at the beginning of this paper, and overcome the negative implications that go beyond the literature, there are a number of institutional issues around the FTA that must be adjusted in order for these to be realised. More than this, there are infrastructural changes that must also occur going beyond the FTA if the New Zealand Government is to achieve the targets it has set itself. This is also true for gains across the FTA and integration into GVCs to be spread equally across the economy.

As we have seen, responses from those interviewed for this study from both the public and private sectors on their reactions to the FTA have been mixed. New Zealand already has a very open economy, and the country is ranked 2nd out of 189 in the World Bank’s Ease of Doing Business Index.¹¹² This suggests that welfare gains brought about by a reduction in tariffs are limited.

¹⁰⁷ CEO, telephone interview, 9 April 2015

¹⁰⁸ Speirs, A. and O’Sullivan, F. (2014) ‘Small and independent, yet Tatua is a big wheel’, *Bay of Plenty Times*, 3 July [Online] Available at: http://www.nzherald.co.nz/bay-of-plenty-times/rural/news/article.cfm?c_id=1503348&objectid=11286288 (Accessed 15 March 2015)

¹⁰⁹ Larson, C. (2014) ‘In China, It’s Meet Me at Tmall’, 11 September [Online] Available at: <http://www.bloomberg.com/bw/articles/2014-09-11/alibaba-sites-drive-chinas-e-commerce-growth> (Accessed 27 May 2015)

¹¹⁰ Woodford, K. (2015) ‘Is China’s infant formula market about to see a price crash?’, 25 March [Online] Available at: <https://keithwoodford.wordpress.com/2015/03/25/is-chinas-infant-formula-market-about-to-see-a-price-crash/> (Accessed 14 May 2015)

¹¹¹ Senior public official, Auckland, 25 February 2015

¹¹² World Bank (2015) *Ease of doing business index*. [Online] Available at: <http://data.worldbank.org/indicator/IC.BUS.EASE.XQ> (Accessed 27 May 2015)

Furthermore, regulatory issues and non-tariff barriers have limited the extent to which New Zealand businesses can enjoy the achievements of the FTA's negotiators. Moreover, considering the importance of New Zealand's integration into global value chains on the Government's policy agenda, the FTA has not achieved as much as it might have. This means the Government must seek to do more, and thus find other tools, to ensure New Zealand's participation in GVCs.

These efforts must involve policies “that improve trade-related infrastructure, increased competition in trade-related services, and provide fiscal and other incentives to foreign firms.”¹¹³ SMEs, which make up 97 per cent of companies in New Zealand and contribute 40 per cent of the economy's value-added output,¹¹⁴ must be fully integrated into these policies. Efforts are being made by BNZ to leverage its existing partnerships in China to connect small New Zealand businesses, of which it counts 100,000 as clients, with clients in China. Pooling of resources and activities between private business, such as BNZ, and NZTE, for example, could increase access for even more companies to essential information.

As mentioned previously, arguably the most significant factor limiting New Zealand's participation in global supply and value chains is its geographical isolation. An UNCTAD report points out that it is not the distance that hinders trade directly, but rather costs of transport and transport connectivity.¹¹⁵ Compounding the issue of distance to markets, with those in Asia still being relatively far away, China still represents significant challenges to businesses. It ranks 96th in the World Bank's Ease of Doing Business Index.¹¹⁶ Interviews reinforced the importance of knowledge of the Chinese market, with a number commenting on the difficulties faced in operating within it. The market is intimidatingly large for any New Zealand producer, and gathering consumer information presents a challenge. The business environment is very different to that in New Zealand, and there are significant cultural differences. Market segmentation was also highlighted as a crucial strategy in the China market, as there are “many Chinas.” High profile scandals have blighted many New

¹¹³ Ibid.

¹¹⁴ Penn, B. (2014) 'China Business: A pathway to partnership', *The New Zealand Herald*, 16 April [Online] Available at: http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11238037 (Accessed 3 April 2015)

¹¹⁵ Nicita, A., Ognivtsev, V. and Shirotori, M. (2013) *Global Supply Chains: Trade and Economic Policies for Developing Countries*. Geneva: UNCTAD, p. 19

¹¹⁶ New Zealand Treasury (2014) *Holding on and Letting Go: Opportunities and challenges for New Zealand's economic performance - A perspective from the Treasury*. Wellington: New Zealand Treasury, p. 17

Zealand companies in China, with some failing, but others, such as Zespri,¹¹⁷ overcoming them.

Ultimately, businesses must make the decision of where to invest and which markets they are going to pursue. Nonetheless, the New Zealand Government does appear to have a disproportionately good relationship with the Chinese Government. This presents an opportunity through which the political relationship can be further leveraged to increase trust between the two countries, and thus facilitate business indirectly. To close the geographical gap to markets and move up the value chain, the most conducive path would be a focus on policies encouraging services, in particular information technology services. This requires a further upgrading of New Zealand's broadband infrastructure and coverage. The OECD has highlighted this as an imperative.¹¹⁸ It has also argued that remote countries such as New Zealand will likely find their comparative advantage shift towards the distance-insensitive export of lightweight, high-value goods and services.¹¹⁹ This comes on the heels of the growing trend in preferences towards timely delivery and improvements in communications technology. Despite this, the reality is that increased demand and trade with emerging economies such as China and India are likely to reinforce and strengthen New Zealand's comparative advantage in primary products.¹²⁰

There is therefore scope for the Government to go beyond the FTA and its current activities in its efforts to support greater integration of firms into GVCs. It is already undertaking promising endeavours towards this end. Stakeholder engagement is high. Further engagement with SMEs in particular would be beneficial, in particular in personalised, cost-effective support of their forays into the vast China market. At home, as highlighted by Secretary to the Treasury Gabriel Makhoul, ensuring that the "underlying infrastructure" in areas such as education and training systems is producing an "Asia-ready" workforce is necessary.¹²¹

Regulatory harmonisation with trade partners is also important, and an area in which MFAT in particular can strive to work with Chinese counterparts. This might decrease the perception by many smaller New Zealand firms that there are excessive risks involved in overseas investment, especially into China. Through investment, companies can locate some of their production

¹¹⁷ Three news (2011) 'Kiwifruit at centre of Chinese fraud case', [Online] Available at: <http://www.3news.co.nz/business/kiwifruit-at-centre-of-chinese-fraud-case-2011090119#axzz3bWipo1xd> (Accessed 29 May 2015)

¹¹⁸ OECD (2013) *OECD Economic Survey: New Zealand 2013*. Paris: OECD

¹¹⁹ Ibid., p. 65

¹²⁰ Ibid.

¹²¹ Makhoul, G. (2015) *Connecting Internationally: Trade is Ancient History*. Speech, Trans-Tasman Business Circle, 31 March 2015

abroad in order to be closer to the end-consumer and international transport infrastructure. In this way, they can access supply chains that are not subject to the same limitations as New Zealand firms are.¹²² Reciprocal investment to supplement somewhat lacking domestic capital could be facilitated by reforms to the Overseas Investment Office (OIO). This institution has the potential to deter investors through “unnecessary cost, frustration and delay.”¹²³ New Zealand can ill afford to deter investment, especially considering that it will require NZ\$210 billion in additional capital between now and 2050 to generate growth and profitability in agriculture alone, based on ANZ capital valuations.¹²⁴ Indeed, one interlocutor commented that in order to make New Zealand a more attractive investment destination, the Government ought to be borrowing large amounts of the “money swishing around the international system at the moment,”¹²⁵ in order to invest in infrastructure.

V Conclusion

This paper has sought to add to the literature on preferential trade agreements a deeper evaluation of the economy-wide impacts they can have. A relative novelty in the literature, the New Zealand-China case shows this from the perspective of a small economy that is somewhat isolated from markets and largely exports primary commodities. The more typical case concerns North-South PTAs, in which the developed partner is the larger economic power, which exports high value manufactured goods. We have found that, as well as those impacts of PTAs anticipated by scholarly writing on the subject, there are a number of implications that go beyond these. The FTA with China reveals vulnerabilities in New Zealand’s growth model. The growth in demand for New Zealand’s products from Chinese consumers following the FTA reveals a possible re-commoditisation of the country’s production. This has the potential to push New Zealand further down the value chain.

The literature revealed that there are both economic and political impacts. Expected economic impacts centre on welfare gains, whilst the political impacts include geopolitical and ideological influence, and the reassurance or pacification of domestic lobbies. Some of these expected impacts were

¹²² Skilling, D. (2007) *Connecting New Zealand to the World*. Auckland: The New Zealand Institute [Online] Available at:

http://nzinitiative.org.nz/site/nzinitiative/files/Connecting_New_Zealand_to_the_world_-_120307.pdf (Accessed 28 May 2015)

¹²³ Pollard, M. (2015) ‘Capital Markets: OIO regime needs a rethink’, *The New Zealand Herald*, 14 May [Online] Available at: http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11447883 (Accessed 29 May 2015)

¹²⁴ ANZ (2012) ‘Greener Pastures: The Global Soft Commodity Opportunity for Australia and New Zealand’, *ANZ Insight*, Issue 3, p. 37

¹²⁵ Senior public official, Auckland, 5 March 2015

confirmed in the interviews with interlocutors from Government, the private sector and other associated organisations. These include welfare gains, access to a stable export market (at least to the extent that demand for New Zealand products is not likely to decrease), an increase in investment flows between the two (although this could be greatly expanded), an increase in consumers' purchasing power, a potential increase in New Zealand's geopolitical standing in the Asia-Pacific region, the cementing of political ties, and a contribution to the project of multilateral liberalisation. Other elements in the literature that are confirmed include the dominance of particular sectors in a country's trade interests (in this case dairy), and issues around the utilisation of preference rates and regulatory barriers more generally. However, the case study of the New Zealand-China FTA adds a number of elements and further implications and impacts to the literature on PTAs.

Government interviewees emphasised the welfare effects of the FTA, whereas these did not appear to be as evident among business – at least, not as a result of the FTA alone. China has become a major trading partner of an impressive number of countries, despite the absence of an FTA. That therefore leads to the question as to whether the explosion in trade between New Zealand and China is the result of the FTA, or would have also occurred in its absence. The perception among the majority of interviewees, in both the public and private sectors, was nonetheless that it has contributed to the increase. The greater benefits to trade appear to be political, on both the Government side and the business side. The FTA seems to re-confirm the positive relationship between the two countries. This inevitably produces positive externalities for New Zealand businesses that operate or seek to operate in China. As many interlocutors noted, it is a sign of “goodwill.” That is, the FTA is a symbol of the importance of China to the New Zealand economy, and therefore has the potential to lead to an indirect economic impact in the longer term. An example of this was raised by one of the interviews above, where a deal was brought to the attention of the Chinese President during a state visit to New Zealand, with the result that it was swiftly concluded. However, there are broader implications of this economic integration with China for New Zealand, which the general literature on PTAs does not explicitly take into account.

Insatiable Chinese appetite for New Zealand's soft commodities has raised concerns about the environmental impact and limits to New Zealand's production capacity to meet that demand. The answer to these concerns has been that firms must both innovate to increase efficiency and productivity, and also invest overseas. Crucial to this enterprise is efforts to move up the value chain. However, investment flows between these two countries have been rather limited, although they are slowly growing, and New Zealand represents a small market for Chinese products. In addition, New Zealand has

limited access to capital, further increasing the barriers to investment by companies in China. Nonetheless, Fonterra, as New Zealand's largest company, has achieved this move up the value chain and has been able to invest in China successfully. However, the majority of New Zealand companies are SMEs, with limited capital and resources. For these firms to expand their activities and enter the Chinese market, investment and scale are required. This is needed so they can also participate in the potential gains of the FTA. Given the vast scale of the market faced by these small producers, cooperation and capitalising on the 'New Zealand' brand are essential. In-depth market knowledge and segmentation are required if firms are to survive in China. The Government has already taken notable steps in facilitating the integration of firms into this market. Support is readily available, and firms are already reaping the benefits of sharing knowledge and learning from the experiences of other firms. This is an example of the support and infrastructure around trade agreements such as this that are required to translate the text of the agreement into tangible economic gains.

Limitations in New Zealand transport connectivity and relatively high transport costs make it more difficult for New Zealand to participate in global supply and value chains. Moreover, services must be increased as a component of total exports, in particular through upgrading of New Zealand's telecommunications infrastructure and information technology sector. The risk in serving China's demand for primary product exports is that New Zealand will not shift its comparative advantage towards lightweight, high-value goods and services that are not distance-sensitive. It is therefore imperative that the effective distance to markets is reduced, through both changes in infrastructure at home, as well as more investment by firms abroad. Interest by China in investing in New Zealand in order to secure supply of certain agricultural products opens the possibility of reciprocal investment in China. Here, the message transmitted through the FTA of openness to investment has certainly been beneficial and has potential to trigger more bilateral investment.

If the Government hopes to increase bilateral trade from NZ\$20 billion to NZ\$30 billion by 2020, adding value will be essential. The above-mentioned measures could aid in achieving this. In order to further facilitate the participation of New Zealand firms in the Chinese market, as well as expansion into other markets, NZTE's staff on the ground could be reinforced. Finally, the Government ought to use its diplomatic clout to pursue greater harmonisation of regulations in the Asia-Pacific region. Given its reputation for being largely neutral in its international affairs,¹²⁶ it has the opportunity

¹²⁶ OECD (2011) *DAC Peer Review of New Zealand*. Paris: OECD, p. 18

to provide normative leadership in further trade agreements in the region. This not only contributes to its goal of increasing momentum towards multilateral free trade, but also eases the integration of New Zealand firms in access and operating in foreign markets. There is thus significant scope for this FTA to effect further positive impacts on the New Zealand economy.

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