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**Investing in the  
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Integration of China  
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**Jason Young**

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## ABSTRACT

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Since the signing of the first free trade agreement (FTA, 2008) between China and an OECD country, New Zealand has deepened its economic relationship with the increasingly important economic power. Review of the FTA has shown both traditional and non-traditional benefits to both countries and the intensification of research cooperation and high level visits and agreements. China is now New Zealand's second largest trading partner and largest source of imports. However, behind the border investment continues to lag far behind the growth in trade in both countries. This has caused a lot of political debate in Wellington. This paper compares foreign investment in rural China by New Zealand's dairy co-operative Fonterra with Chinese investment in New Zealand's dairy industry by Chinese companies Bright Dairy and Shanghai Pengxin. The paper argues these investments represent new trends in the China-New Zealand relationship and identifies a series of challenges and implications to investing in the economic integration of China and New Zealand.

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## ABOUT THE AUTHOR

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Jason Young is Lecturer in Political Science and International Relations at Victoria University of Wellington in New Zealand. Jason is currently completing a book on the *hukou* institution and conducting research on the development of China-New Zealand economic relations post Free Trade Agreement with a particular focus on agricultural reform in China. He is a research associate of the New Zealand Contemporary China Research Centre, member of the New Zealand Asian Studies Society and recipient of the Sir Desmond Todd Memorial Prize for the most outstanding PhD in Political Science or International Relations. His research interests include Chinese politico-economic development, the international relations of East Asia, and New Zealand-China trade and investment.

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## Investing in the Economic Integration of China and New Zealand

Jason Young

### Introduction

Since the signing of the first free trade agreement (FTA, 2008) between China and an OECD country, New Zealand has deepened its economic relations with the increasingly important economic power. Review of the FTA has shown both traditional and non-traditional benefits to both countries and the intensification of research cooperation and high level visits and agreements. China is now New Zealand's second largest trade partner. This trend is part of a broader economic turn towards East Asia characterised by deepening trade relations and relative decline of trade with traditional trading partners such as the US and UK. Investment however, continues to be dominated by the US, UK and Australia and East Asian economies, particularly China, remain minor investment partners. This reflects current imbalances in the world economy. The rise of East Asia as an economic power has seen countries such as China become major regions of economic activity that play a major trading role. However, only recently have Chinese companies looked outside and attempted to invest globally. To date, Chinese investment flows have not matched the stock of investment from developed countries. This is slowly changing but it will likely take many more decades for China's share of global investment to be comparable to its share of economic activity and trade.

This paper argues the discontinuity between trade and investment in the New Zealand-China economic relationship represents a broader global imbalance in the world economy. Moreover, in the case of New Zealand, this imbalance has emerged after the signing of a comprehensive FTA covering trade, services and investment. Post-FTA trade has increased significantly but investment remains weak showing

deeper forms of economic integration with unfamiliar economies that bridge cultural and development divides (East/West & North/South) require more than just government to government preferential trade agreements (PTA). Economic integration in this case is therefore not a simple step process where removing barriers to trade and investment are followed first by increased trade and then by increased investment. Rather, there is a significant lag in investment relations as behind the border integration requires time for the business community and public to adapt to new economic relations.

The argument is presented over five sections. The first overviews changes in the world economy and argues a major imbalance between shares of trade and economic activity on one hand and shares of global investment on the other has developed. The second section introduces the impact these changes are having on small states such as New Zealand. This is followed by an overview of the growth of the New Zealand-China relationship that culminated in the first FTA with China and an OECD nation in 2008. Analysis of the economic relationship post-FTA is then presented showing how the growth in bilateral trade has not been matched by growth in two-way bilateral investment. Two case studies are then presented to highlight the many non-governmental challenges to increasing investment: Fonterra's investment in the Chinese dairy industry and Bright Dairy and Shanghai Pengxin's investment and proposed investment in the New Zealand dairy industry. The paper concludes that economic integration in the New Zealand-China case is not a simple step process where increased trade automatically leads to stronger investment ties. Rather, significant non-government barriers to investment are identified. For New Zealand investors, this includes the problem of size and a lack of detailed understanding of China's regulatory and cultural environment. For Chinese investors, this includes the fact they have only recently become global investors, a lack of understanding of the role of domestic law screening investment and problems with local perceptions of Chinese investment in New Zealand farmland.

## **A New World Economy?**

The world economy has changed dramatically over the past few decades. Only three decades ago it was still possible to talk about a western-

dominated world economy. In 1980, North America and Western Europe together accounted for a 60% share of global GDP (PPP). This had dropped dramatically to 41% by 2011. The Major Advanced Economies (G7) accounted for a stunning 56% of Global GDP (PPP) in 1980 but only 39% in 2011 motivating the rise of a new organization, the Group of 20 (G20). The long-term slow growth of the developed world combined with rapid growth in many parts of the developing world has fundamentally reshaped the world economy and created new areas of economic activity.

The most significant growth has been in East Asia. Even in the year 2000 it was clear the world was witnessing a resurgence of East Asian economic power (Cohen 2000). Accounting for only 12% of global GDP (PPP) in 1980, by 2011 East Asia had nearly doubled its share to 23.5%, surpassing both Western Europe (18.3%) and North America (23.2%). By sustaining three decades of rapid growth at a near average of 10% per annum, China grew its share of the world economy from 2.3% in 1981 to 14.4% in 2011 (IMF 2011, see figure 1 in appendix 1). These statistics suggest a new world economy has emerged in which there are now three regional centres of economic activity, North America, Western Europe and East Asia. However, global investment statistics paint a very different picture.

North American and Western European dominance of investment in the world economy continues. The share of global stock of foreign direct investment (FDI in US dollars) in East Asia has grown from 247 billion in 1990 to 2 trillion in 2010. But as a share of global FDI stock this represents a drop from 12% to 11% while countries other than in these three economic regions have grown their share from 17% to 30%. North America has dropped its share of stock of global FDI from 32% to 23% over the 20 year period and Western Europe has dropped from a 39% to a 36% share. East Asia has maintained a more than 10% share as investment increasingly moves into the developing economies of South America, Southeast Asia and South Asia (UNCTAD 2011).

Western Europe and North America are still the major sources of global FDI stock (see figure 2). In 1990, North America accounted for 39% of the global outward FDI stock. This had dropped to 27% by 2010. Western Europe accounted for 42% in 1990, rising to 49% in 2010. East Asia still accounts for 12% of global outward FDI, the same as in

1990 (UNCTAD 2011). But investment flows suggest these trends are also starting to reflect the locus of economic activity emerging in East Asia. China is becoming an important global investor. Inward FDI flows to China (including Hong Kong and Macao) grew from 107 billion to 177 billion from 2005 to 2010, a growth of 65% over 5 years. Over the same period outward FDI flows grew from 40 billion to 144 billion, a growth of 264%. While the measure of inward FDI flows is comparable to the US level, the stock of FDI in China is only roughly half. The stock of outward FDI has grown from 2% of the US outward FDI flow in 1990 to a value equivalent to 26% of the US amount in 2010 (UNCTAD 2011). These changes have profound impacts on the trade and investment relationships of small states.

## **A Small State in a Changing World Economy**

New Zealand is a trading nation. With a small population and limited land resources, it is dependent on international trade in goods and services for export earnings and access to global markets for imports and capital flows. Small states are vulnerable economies in a global trading order. New Zealand, like other small states in Europe, has approached the challenge of globalization by promoting multilateralism, the lowering of tariffs and the signing of bilateral, regional and global trade agreements (Katzenstein 1985). The stagnation and at times dramatic decrease in trade with traditional trading partners such as the United Kingdom has seen successive governments focus on expanding trade with the emerging economies of East Asia. New Zealand's trading relations are now spread wide and increasingly dependent on East Asian economies. The New Zealand Government has developed a building block strategy toward regional integration as a means of confronting the challenges of limited resources in an open and highly competitive world market. The state has promoted North-North and North-South PTAs in an effort to forward regional integration and a multilateral framework for an open trading order in the Asia Pacific. But as the paper shows, getting beyond trade to a deeper level of economic integration is challenging.

New Zealand's approach to regional integration has been shaped by both positive and negative experience in the new world economy. Two negative experiences motivated policymakers to play a more proactive

role. First, Britain's accession to the European Economic Community (EEC) created a negative trade diversion effect for New Zealand. The loss of a 'special relationship' due to Britain's accession and new European market requirements, especially the Common Agricultural Policy (CAP), created the need to reorient New Zealand trade. Second, the creation of the North Atlantic Free Trade Area (NAFTA) decreased the competitiveness of New Zealand product in North America, in particular in the Mexican market, as New Zealand products continued to incur tariffs while Canadian and United States (US) exporters experienced the elimination of tariffs (Finny 2010). Positive motivation came through Closer Economic Arrangements (CER) with Australia. Through CER policymakers learnt the benefits of a small economy opening to larger markets and the importance of PTAs for maintaining access to global markets.

These lessons and the stalling of multilateral agreement on trade, services, investment and regulatory harmonization in the Doha round of the World Trade Organization (WTO) led New Zealand, along with countries like Singapore, to pursue greater regional integration through a series of comprehensive bilateral PTAs. These include bilateral agreements with Australia, Singapore, Thailand and Malaysia that provided the impetus for the ASEAN-Australia-New Zealand Free Trade Agreement (2010, see table 1), and the plurilateral agreement the Trans-Pacific Strategic Economic Partnership (P4, 2005) as well as bilateral agreements with China and Hong Kong and a possible expansion of the P4 to nine countries, including the US, in the Trans-Pacific Partnership (TPP). New Zealand efforts have had a marked impact on the process of Asia-Pacific regional integration and constitute a viable small state strategy toward economic integration with East Asia. Shifts in New Zealand's trade relations reflect changes in the world economy.

In 1990 only 24% of New Zealand merchandise imports came from Asia but by 2010 this had grown to 43%. Over the same period, the share from Europe dropped from 25% to 16.5%, the share from North and Central America dropped from 20% to 12.3% and the share from Oceania (including Australia) dropped from 21% to 18% (ADB 2011, see figure 3). Asia is now the dominant origin of New Zealand imports. A similar trend is evident for New Zealand merchandise exports. In 1990, 30% of New Zealand merchandise exports went to Asia. This had grown

to 38% by 2010. Over the same period the share heading to Europe had dropped 18.4% to 11.8%. The share destined for North and Central America dropped from 16.8% to 11.3%. Only exports destined for Oceania, predominantly Australia, have experienced a similar increase rising from a 21% share in 1990 to a 25% share in 2010 (ADB 2011, see figure 4). New Zealand exporters are increasingly reliant on consumption growth in Asia and Australia.<sup>1</sup>

As former New Zealand Prime Minister Helen Clark stated, “Our objective must be to nurture and deepen our Asia relationships so that New Zealand can play an active role in the growth and prosperity of the Asian region” (MFAT 2007:2). A central part of this strategy to diversify economic relations into the Asian region has been successive New Zealand government efforts to nurture a strong economic relationship with China. This culminated in New Zealand becoming the first OECD country to sign a free trade agreement with the increasingly important economic power.

## **Growth of the New Zealand China relationship**

The New Zealand China economic relationship has developed strongly since diplomatic ties were established in 1972. The most recent decade has seen the relationship flourish. Both sides refer to the ‘four firsts’ as the cornerstone of the contemporary economic relationship. These are: New Zealand was the first country to agree bilaterally to China becoming a member of the World Trade Organisation (WTO); New Zealand was the first country to recognise that China had established a market economy system (the US and European Union have not recognised China as a market economy); New Zealand was the first OECD country to begin negotiating an FTA with China in November 2004; and finally, New Zealand was the first OECD country to sign an FTA with China in April 2008.

The New Zealand-China Free Trade Agreement (NZCFTA 2008) is the most important trade agreement for New Zealand since Closer Economic Relations with Australia and an incredibly important agreement for the region. It took 3 years and fifteen rounds of negotiations to conclude. The agreement heralded China’s first PTA with an OECD economy and a

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<sup>1</sup> Australia is also increasingly reliant on trade with Asia. China is its top trading partner.

comprehensive PTA that included provisions on trade in goods and services, investment, education, science and technology and other cooperation (China Free Trade Area Service Website 2008). By 2016, all trade from China to New Zealand will be duty-free. By 2019, over 96% of trade from New Zealand to China will be duty free. These measures reduce barriers to China-New Zealand trade by making products and services from each country more competitive in the respective markets. The Chinese trade agreement has already had a strong impact on the New Zealand-China economic relationship with “20% growth in bilateral two-way merchandise trade in the first year following entry into force [and] a doubling of bilateral trade in the past five years” (MFAT 2010:2). Chapters on investment, education, science and technology, and regulatory cooperation ensure the NZCFTA will continue to impact the New Zealand-China economic relationship in the coming years.

Aside from the direct economic benefits, the strategic benefits of this agreement are immense. NZCFTA links the New Zealand economy to the heart of Asia avoiding any potential trade diversion for New Zealand through a ‘splintering’ of the region or the creation of opposing trade blocs if there is a breakdown in the consensus on open regionalism. This is incredibly important for a small trading nation that cannot afford to be shut out from fast developing markets that increasingly demand agricultural products nor traditional developed markets which remain crucial to maintaining New Zealand’s standard of living. The fact that this agreement introduced cooperation over the North-South divide in the Asia Pacific is particularly important for regional development.

In an economically diverse region like the Asia-Pacific, North-South trade agreements are an important element of regional integration. As Zhou Jinzhu found in her analysis of the NZCFTA and the proposed Australia-China FTA, “the static effect is no longer the main reason to build RTAs [regional trade agreements]. The dynamic effect is more likely to promote economic vitality and development, and non-traditional gains have significant diplomatic and political meaning making them the main considerations for both the developed and developing economies to pursue RTAs, especially the asymmetric North-South FTAs” (Zhou 2010:110). For Asia Pacific regional integration to progress, the divide between developed and developing countries must be bridged.

The NZCFTA is an example of successful crossing of the North-South divide. For China, the behaviour of the New Zealand Government and the small size of the New Zealand economy lent itself to promoting economic cooperation with a developed western country. New Zealand had recognized China's market economy status and had formally supported China's bid to join the WTO. This strategy allowed for the successful opening of negotiations. New Zealand's experience negotiating comprehensive agreements and good reputation as an economic partner opened the way for this 'experiment' in North-South trade agreements. 'Beijing's changed views on preferential trade' as shown in its willingness to seek out small developed countries and enter into comprehensive cross-regional preferential trade agreements (Lanteigne 2010) provided New Zealand with a strategic window of opportunity that was adroitly managed by the New Zealand bureaucracy and executive.

New Zealand has begun to enjoy not only increased trade with China but also the strategic benefits of the agreement. In January 2011, the New Zealand-Hong Kong, China Closer Economic Partnership entered into force including a binding agreement to conclude an Investment Protocol within two years (MFAT 2012). As New Zealand's ninth largest export destination, Hong Kong is an important trade and investment partner and a window into China. Likewise, the commencement of the final phases of a joint feasibility study of an Economic Cooperation Agreement between New Zealand and Chinese Taipei could also further link New Zealand business to this dynamic region. For Taiwan, these negotiations (and those with Singapore), form "part of its efforts to achieve regional economic integration and pursue further trade liberalization. As both Singapore and New Zealand are founding members of the TPP, Taiwan hopes that signing trade agreements with the two nations will pave the way for its eventual inclusion in the multilateral trade agreement" (Chan 2011). As Chinese Taipei has signed an Economic Cooperation Framework Agreement (ECFA 2010) with China, the way is open for further economic integration in the region.

Post-NZCFTA, the economic relationship has been nurtured by a series of cooperative agreements and high level visits. No less than seven New Zealand ministerial delegations went to China in 2010 alone. Prime

Minister John Key met with Premier Wen Jiabao in July in 2010 and they agreed to double two-way bilateral trade over the next five years (NZPA 2011), as well as jointly launch the formal framework for bilateral science cooperation, the New Zealand-China Strategic Research Alliance. Chinese Vice-Premier Li Keqiang visited Lincoln University's training dairy farm in Christchurch in 2009. Vice-President Xi Jinping visited New Zealand in June 2010. Deputy Vice-Premier Hui Liangyu visited in 2011. A series of visits and delegations are planned for 2012.

These visits have not only improved the economic relationship through trade and investment delegations but also resulted in a series of regulatory cooperation agreements, an increase in opportunities for joint research projects, qualification recognition and important programmes in areas such as agricultural science and food safety. In early February 2012, the New Zealand Government launched its 'China Strategy', *Opening Doors to China*. Goals and priority actions include: retaining and building a strong and resilient political relationship; doubling two-way goods trade to \$20 billion by 2015; growing services trade (education by 20 percent, tourism by at least 60 percent, and other services trade) by 2015; increasing bilateral investment to levels that reflect the growing commercial relationship; and finally, growing high quality science and technology collaborations to generate commercial opportunities (NZTE and MFAT 2012:16). Reducing barriers to trade and investment has been followed by rapid increases in bilateral trade but bilateral investment levels remain small.

## **Trade and Investment Post-NZCFTA**

The impact of the FTA and the strength of the economic relationship with China is evident in the growth of two-way bilateral trade. A reduction in barriers to trade and favourable relations with Chinese businesses has led to a 20% growth in bilateral two-way merchandise trade from 2008 to 2009 (MFAT 2010). In 2000, the share of New Zealand exports destined for China was only 2.93% of all New Zealand exports. This share hovered around 5% from 2002 to 2008. After the FTA came into force, China quickly moved from fourth largest to second largest export destination accounting for 12.23% of all New Zealand exports in the year ending June 2011 (Statistics New Zealand 2011, see

figure 5). Chinese imports have also risen steadily from fourth largest country of origin in 2000 to almost first equal with Australia in the year to June 2011 (Statistics New Zealand 2011, see figure 6). China became the largest source of imports to New Zealand in the year ending 2011 (Xinhua 2012). On current trajectories, China will maintain its number one spot as the largest source of New Zealand imports and is likely to overtake Australia to become the largest export market for New Zealand products and services. The New Zealand-China trade relationship is growing rapidly. Growth in the field of investment pales in comparison.

New Zealand's investment relations remain tied to those countries which traditionally were the most significant trading partners. Of the 301 billion New Zealand dollars (NZD) of total investment in New Zealand and the 165 billion NZD of total investment overseas at year end March 31, 2011, the vast majority is related to traditional trading partners (see figure 8). 67% of total investment in New Zealand comes from three economies: Australia 36%; United Kingdom 16%; United States 15%. 57% of total outward New Zealand investment goes to the same economies: Australia 31%; United States 18%; United Kingdom 8% (Statistics New Zealand 2011, see figure 7). For each of these economies, the traditional trading relationship has dropped as a share of New Zealand's overall economic relations but the investment relationship remains strong.

The inverse is true for China. While the trading relationship has grown rapidly only small gains have been made behind the border. As of year-end March 31, 2011, the total stock of Chinese investment in New Zealand was only 1.8 billion NZD, 0.6% of total investment stock in New Zealand. This represented a slightly larger share of total investment stock from 2001 when it was 518 million or 0.3% of total investment stock in New Zealand. Similarly, New Zealand's total investment stock in China has grown from 91 million NZD in 2001 to 769 million in year-end March 31, 2011, growing from 0.1% of total New Zealand investment stock abroad to 0.5% (Statistics New Zealand 2011, see figure 9).

Neither the flow of total investment from China to New Zealand nor the flow of total New Zealand investment to China has increased dramatically (see figures 10 and 11). This suggests the share of New Zealand-China two-way bilateral investment stock is likely to remain

low in the foreseeable future. Even when adding the stock of investment from and to Hong Kong, Macao and Taiwan, the investment relationship still pales in comparison to New Zealand's traditional investment partners (see figures 12 to 13). Moreover, New Zealand still invests more in Hong Kong than mainland China. Taiwan alone invests more in New Zealand than mainland China, with a total investment stock of 2.6 billion in year-end March 31, 2011. Investment from Hong Kong has actually decreased from 11.8 billion to 3.6 billion over the ten year period to March 31, 2011 (Statistics New Zealand 2011).

The 2-year review of the FTA jointly written by the New Zealand and Chinese Governments stressed that two-way investment has grown but “there is considerable scope for further investment, particularly in the agri-business (food processing, aquaculture, dairy), forestry, education...” (MFAT 2010:41). At the time of writing the Chinese side expressed some concern over the role of the Overseas Investment Office screening investments. The same report noted that even though New Zealand investment in China was at an historical high in 2009, the overall New Zealand share of China's total investment had declined. The review therefore also showed both parties recognize the growth of the trading relationship has yet to be mirrored in the bilateral investment relationship.

In March 2012, New Zealand Minister of Trade, Tim Groser, argued New Zealand's current imbalance between trade and investment partners will change in the future. “Trade and investment are increasingly linked in today's global supply chain. It is inconceivable that this vast expansion of China-NZ trade links would not be accompanied by a major expansion of Chinese investment in New Zealand and vice versa. If you look at the stock of foreign investment in New Zealand it is Australian, British, and US that dominate it. Why? Because these countries have been our major economic partners. This will change in line with the very radical shifts in New Zealand trading partners. It needs to change” (Groser 2012).

The following two sections look at examples from the two-way bilateral investment relationship in the dairy sector. The dairy industry is chosen because it makes up a large proportion of New Zealand exports to China and is of strategic interest to Chinese investors. For New Zealanders, investment in the development of China's agricultural sector presents

opportunity to expand and to bring the considerable competitive advantage of New Zealand agribusiness to bear on a growing sector of the Chinese economy currently underinvested in. However, as both cases show, there is a considerable array of challenges to overcome if New Zealand-China economic relations are to witness ‘a major expansion of Chinese investment in New Zealand and vice versa’.

## **Fonterra New Zealand’s Investment in Chinese Agriculture**

China had entered into high-quality agreements with OECD countries on investment before the signing of the New Zealand-China FTA (MFAT 2010) but the FTA clarified and institutionalised New Zealand investment in China. Chapter 11 of the FTA accords New Zealand investors ‘national treatment’ (article 138) and ‘most-favoured-nation treatment’ (article 139) to ensure they have the same access to China as other foreign investors and that any future provisions in FTAs between China and other countries are also extended to New Zealand investors. The FTA provides protections for New Zealand investors in China and institutionalises measures for dealing with any issues requiring state arbitration. However, Annex 8, part A, clearly states under ‘limitations on market access’ that “The land in the People's Republic of China is State-owned. Use of land by enterprises and individuals is subject to ... maximum term limitations” of between 40 to 70 years. This means New Zealand agribusinesses cannot ‘own’ land in China but must lease it from the state, or in the case of rural land, deal with local government and the collective. This creates a unique challenge for New Zealand’s leading agribusiness, Fonterra.

The Fonterra case is an example of a New Zealand company that has attempted to position itself to take part in the rapid development of the Chinese dairy industry. Traditionally, foreign investors looked to China as a source of cheap labour to cut down manufacturing costs of products predominantly destined for markets in the developed world. This is the case for companies such as Nike or Levis. But with the growth of Chinese domestic consumption, more and more companies are setting up production in China to source growing demand from in China. Coca Cola, KFC and McDonalds are early examples of companies

using this strategy. The massive growth in Chinese dairy consumption is an area that New Zealand's dairy cooperative Fonterra have sought to be a part of.

Fonterra is one of New Zealand's first companies to approach the China market using this model on a large scale. Fonterra has a 30-year history in China (formerly New Zealand Dairy Board) but only in the last 5 years has it made efforts to invest behind the border. The first such effort came in 2006 by investing a 43% stake in one of China's largest dairy companies at that time, Shijiazhuang Sanlu Group. As part of this joint venture a pilot Fonterra farm in Tangshan, Hebei was established. This is the first of Fonterra's China farms and set the model of barn farming New Zealand-bred cows to produce a large quantity of raw milk which is then on-sold to producers in the Chinese market. While the Tangshan pilot farm was a resounding success, the partnership with Sanlu led to Fonterra's greatest challenge.

In September 2008, Fonterra publicized through the New Zealand Government the tainted milk scandal involving Sanlu products. Milk suppliers (many small farmers) had been adding melamine to milk to artificially boost protein levels. This resulted in an estimated 300,000 Chinese babies becoming sick and tragically six deaths due to kidney problems caused by drinking melamine tainted milk powder. As a result, confidence in the Chinese dairy industry eroded, Sanlu became insolvent, Fonterra lost its investment in the company, and many people were convicted including 2 people sentenced to death in 2009. Many other companies were also implicated in this scandal. Fonterra then poured resources into the Fonterra Rural Maternity and Infant Healthcare Community Program in partnership with the Soong Ching Ling Foundation to 'deliver better healthcare services to rural women and children' (Ferrier 2010) and moved from processing milk sourced locally in China to producing milk for the local market (supplying local producers like Mengniu, Yili or Bright Dairy) whilst continuing to focus on selling New Zealand produced goods (both milk solids and some value-added products) in the Chinese market.

Communications with Fonterra suggest the Sanlu tainted milk scandal was a major catalyst to focus on the new model of investment in the Chinese dairy industry. The Tangshan farm remains a joint venture but no longer with Sanlu. Beijing Capital Agricultural Group owns a 15%

share as a 'silent partner'. Tangshan has a local workforce of 120 staff and has grown its original 3000 New Zealand cow herd to 7000 to produce 25 million litres of milk in the 2009/10 year. It was projected to produce 28 million litres of milk in the 2010/11 year. The success of the Tangshan pilot farm has encouraged Fonterra China to expand its farming operations in China.

In October 2010 Fonterra and the Yutian County Government in Hebei signed an agreement to develop a farm in their agricultural development zone. Modelled on the Tangshan farm it involved a NZD 42 million investment, 3000 New Zealand cows and 100 local staff. Construction of the farm took roughly a year and milking began late 2011. Fonterra have announced another site for building their third farm in Yutian through a US \$40 million investment with the Yutian County Government (New Zealand Herald 2011a). These farms differ only slightly to the Tangshan farm and were also acquired through a variety of land-leases though this time without a local joint venture partner.

Here lies the second of Fonterra's challenges. The land-lease system in rural China is a hybrid system mixing market and command economic systems. Land is no longer managed and used by the collective as it was under the commune system, but it is still owned by the collective who administer leases to rural people through the household contract responsibility system (HCRS). With the hollowing out of rural areas through urbanisation, rural land is increasingly being collected into large blocks for either non-agricultural use or large commercialised farming. This can happen through the confiscation of land by the state turning collective-owned (and household leased) land into state-owned land; the rural collective cancelling leases, collecting up a large block of rural land and then renting it to commercial interests; a commercial interest arranging individual sub-leases with rural residents; or finally, rural residents working together by pooling land and resources to create an agricultural cooperative. Fonterra have successfully negotiated this hybrid system and secured leases for their farms in Hebei.

Fonterra's China strategy is in its early stages. The lessons learnt from the San Lu infant milk formula scandal have been costly and shaken the very foundations of food safety in China. Since then Fonterra have moved away from dairy processing and made efforts to acquire farmland to build up a network of farms in Hebei to ensure they can control milk

sourcing in an agricultural sector that is still finding its feet in terms of regulation and enforcement of food safety standards. Fonterra's current farms are part of a plan to acquire 20 farms in 4 hubs that could be used to source milk for possible future dairy processing (Christian 2011). Other New Zealand agribusinesses could follow the Fonterra model but a major obstacle to investing in the development of Chinese agriculture relates to limitations of size, resources and compatibility with the Chinese regulatory environment. The challenges of Chinese investment in New Zealand are of a very different nature.

## **Chinese Investment in New Zealand Agriculture**

Before signing the FTA, Chinese investment in New Zealand was already subject to an Investment Protection and Promotion Agreement (IPPA) (MFAT 2010). When Chinese Deputy Premier, Hui Liangyu, visited New Zealand in September 2011 an important memorandum of understanding on investment was signed with one of China's largest financial institutions, the China Development Bank (New Zealand Herald 2011b). But it is the FTA which provides the protections for Chinese investors in New Zealand and institutionalises measures for dealing with any issues requiring state arbitration. Chapter 11 of the FTA accords investors from China 'national treatment' (article 138) and 'most-favoured-nation treatment' (article 139). The inclusion of these articles signals the willingness of the New Zealand Government to sign a comprehensive FTA with China and to attract Chinese investment behind the border. This said, the FTA did not allow Chinese investors to bypass New Zealand domestic law requiring screening of overseas investment.

Annex 8 part B, of the FTA clearly states under 'limitations on national treatment' that Overseas Investment Commission (OIC) approval is required for an 'overseas person' for most investments over \$NZ10 million and "OIC consent is required, regardless of the dollar value of the investment, for acquisition of rural land" (NZCFTA 2008). Moreover, for state arbitration of investment disputes, Chinese investment in New Zealand that is subject to approval under the Overseas Investment Act (OIA 2005) is not subject to state arbitration as this only occurs with disputes "directly concerning investments" (i.e. actual investments

which have been made after Overseas Investment Office , OIO, consent) (MFAT 2008:37). In 2012, this stipulation and a judicial review of investment decisions by the OIO created much uncertainty for not only Chinese investors but all overseas investors looking to invest in New Zealand's agricultural industry. Public reaction to China's growing interest in New Zealand agriculture, in particular farmland, was the catalyst for this review.

Chinese investment is only now becoming of interest to the New Zealand public as it becomes more visible in wake of China's 'go abroad' strategy. This strategy is a logical extension of prolonged economic growth and accumulation of foreign currency reserves valued at 3 trillion USD. The state has encouraged domestic companies to invest overseas since before the turn of the century but not since 2005 has a presence begun to be felt, a trend that has intensified since the global financial crisis. Overseas investment from China will likely increase in the coming decades due to the growing perception in Beijing that Chinese companies need to secure resources, market share and access to skills and technology. This strategy is hardly unique to China. Like many other countries, Chinese interests in New Zealand are focussed on New Zealand's productive agricultural sector, particularly the dairy sector. There is an economic motive investing in New Zealand's state-of-the-art dairy industry but also a growing concern surrounding food security.

China has an increasingly challenging strategic goal of ensuring food security for a large modernizing population. Chapter 4 of the *Medium Term Plan for National Food Security (2008-2020), Important Tasks for Ensuring Food Security*, devotes a section to *Strengthening International Food Cooperation* that directs companies to "Strengthen intergovernmental cooperation and establish long-term and stable agricultural industry (food) cooperation relationships with some important agriculture producing nations. Bring into effect the agricultural 'go abroad' strategy, encourage domestic enterprises to 'go abroad', establish a stable and reliable system of sourcing food imports, [and] increase the ability to safeguard domestic food security" (CCCPC and SC 2008). Chinese firms are keen to acquire both technology and knowhow involved in New Zealand's dairy sector and to own farmland and processing facilities that currently export to China.

The most successful venture to date has been China's Bright Dairy stake in Canterbury's Synlait dairy processing operation. Synlait fell on hard times after failing to raise capital after listing on the NZ stock exchange allowing the purchase of a 51% controlling interest in the processing arm for \$82 million in 2010 (New Zealand Herald 2010). Synlait Milk CEO, John Penno, argues the Bright Dairy deal gives Synlait greater access to the Chinese market, strong marketing and brand capacity and the needed capital injection to grow (Radio New Zealand 2010). With the recent opening of the largest infant formula facility of its type in the Southern Hemisphere, Synlait's future seems bright. They are announcing new products for the rapidly growing Chinese dairy market and launching their new Pure Canterbury infant formula in Shanghai priced at \$80/can (New Zealand Herald 2011c). Little negative public reaction occurred when the deal was announced.

But investment by Chinese companies in New Zealand agribusiness has not always been smooth. Many Chinese investors are aware the New Zealand Government provides little incentive in the form of tax breaks or other breaks as is often common in China. The issue of investment being subject to OIO approval is also of great interest to investors. Chinese investment in New Zealand farmland became a major source of public debate when Natural Dairy, led by Jacky Chen, put a bid on the bankrupt Crafar Farms. Eventually the OIO rejected the bid after much public debate and issues surrounding businesswoman May Wang and Natural Dairy's sister company, New Zealand-based UBNZ Asset Holdings. Cabinet ministers Maurice Williamson and Kate Wilkinson declined the bid on behalf of the OIO after its directors and frontwoman May Wang failed a "good character" test. The public fallout did little to improve the public perception of Chinese investors.

The same farms now have an offer on them from Shanghai Pengxin Group/Milk New Zealand (New Zealand Herald 2011d). This offer is far higher than any other offer, for example Landcorp or the Sir Michael Fay-led consortium offer which 'played the local card' (O'Sullivan 2011). Sources indicate it is far more reputable a company than Natural Dairy and that a lot lies on the OIO decision. Recent media attention around this new bid plays on public fears of little known Chinese companies in New Zealand (see for example Fox 2011). Political Counsellor at the Chinese embassy in Wellington, Cheng Lei, made a rare public statement to media to try to allay fears of Chinese investment in New

Zealand and to stress the importance of investment to the deepening of New Zealand-China relations (Radio New Zealand 2011). However, polls commissioned by the rival Fay-led consortium suggest there is strong opposition to further sale of New Zealand farmland to overseas interests (TVNZ 2012) in light of the Shanghai Pengxin bid.

The OIO approved the Shanghai Pengxin bid for the Crafar farms in early 2012 (LINZ 2012) and the deal was signed off by cabinet ministers. This led to strong public outcry. A local rival bidder filed for an unprecedented judicial review of the investment office decision. This review was accepted and the New Zealand High Court ruled the OIO applied the wrong test for economic benefit as stipulated in the Overseas Investment Act (ILO 2012). The decision now needs to be reviewed in light of the court ruling. Overseas investment in New Zealand farmland must now satisfy a different kind of test for ‘economic benefit’. Where previously OIO decisions used a test based on whether that investment takes place or not they must now compare the proposed investment to a hypothetical local investment. This has large ramifications for not only how the OIO will review Chinese investment in New Zealand but all overseas investment. At the time of writing the Shanghai Pengxin bid had been accepted again by the OIO and cleared by Cabinet but remained in limbo due to further court action by the Fay-led consortium.

In light of these challenges, it is instructive to see the government of the day maintaining a consistent approach to Chinese investment over the media craze and political debate surrounding the judicial review. Prime Minister John Key and New Zealand Government ministries continue to promote bilateral two-way investment with China. This is clear in the China strategy also released early 2012. The fourth ‘goal and priority action’ of *Opening Doors to China* is to “increase bilateral investment to levels that reflect the growing commercial relationship with China” (NZTE and MFAT 2012:25). Similarly, Political Counsellor Cheng Lei argues New Zealand and Chinese economies are complimentary and that bilateral two-way investment “is in the interests of both our countries and peoples” (Chapman 2012).

Chinese investment in New Zealand is set to rise in spite of these challenges. Agriculture, clean technology, information and communication technologies, aquaculture and resources (minerals, coal)

are the five areas of most likely interest. Recent acquisitions in New Zealand include Agria Corporation buying a controlling stake in PGG Wrightson and Haier taking a 20% stake in Fisher & Paykel Appliances. Huawei are bidding for telecommunications contracts. A2 Corporation is looking to invest in dairy processing. There is talk of enterprise partnerships in the mining industry. Farmland and dairy processing are still of significant interest.

Chinese investment in New Zealand Government bonds and public debt is reportedly rising fast (New Zealand Herald 2011e) but to date it appears the situation for Chinese bond investment mirrors the private sector. Foreign investors have certainly increased their share of Government debt but the bulk of this debt is owned by Belgium, the Netherlands and Luxembourg (70%), the UK and Ireland (7.8%), Japan (7%), Australia (6.6%) and the US (5.1%) (New Zealand Herald 2011f). Even if China accounted for the entire remainder, this would only be 3.5% of total Government debt. It is hard to find detailed information on the origin of investments in New Zealand securities and treasury bonds from the New Zealand Debt Management Office or Treasury data. Secondary sources suggest China is beginning to invest more in public debt but is still a long way off becoming a major player.

## **Economic integration, trade and investment**

This paper has shown there is a discontinuity between government to government efforts to lower barriers to trade and investment and the levels of two-way bilateral investment in the New Zealand-China economic relationship. While trade has grown substantially post-NZCFTA, investment levels in both economies remain a tiny share of New Zealand's investment. This suggests economic integration between New Zealand and China will require some time before the non-government barriers to behind the border investment are removed. Economic integration in this case is therefore not a simple step process where removing barriers to trade and investment are followed first by increased trade and then by increased investment. Rather, there is a significant lag in investment relations as behind the border investment requires time for the business community and public to adapt to new economic relations.

This year is the 40th anniversary of diplomatic relations with China and it is likely new efforts to deepen the relationship will occur. To date, it is government efforts that have promoted the investment relationship. On the Chinese side, the state has signalled its intention to increase investment overseas through the 'go abroad' strategy. The *National Food Security Medium Term Plan* directly identifies investment in agribusiness and agricultural production as critical to enhancing China's ability to use international trade as a mechanism to supplement an inability of domestic food supply to meet demand. On the New Zealand side, the potential for growth from investing in the Chinese agricultural sector comes from the fact that New Zealand agribusinesses have most favoured nation status, considerable goodwill through the FTA and much to offer the developing Chinese industry. The pace of development in China suggests the window of opportunity for New Zealand investment created by years of diplomacy and negotiation will not last.

The paper identified a number of non-government challenges to deeper economic integration between New Zealand and China to explain why there are strong and rapidly growing trade relations but very little movement in the area of investment. Investment represents deeper economic integration than trade and therefore brings with it more challenges. For New Zealand investment in China, the Fonterra case highlights a number of issues. First, there is the question of size. Investing in such a large and not well-understood market requires resources and high start-up costs most New Zealand companies do not possess. The New Zealand economy is dominated by small and medium sized enterprises. Second, the complexity of the Chinese market and issues with the regulatory environment present a formidable challenge as shown by the differences in food safety standards and the land tenure system. Finally, there are a number of cultural and relationship issues which New Zealand companies are just beginning to grapple with as their knowledge and understanding of Chinese business practices grows from a very low base. However, the Fonterra case shows these issues can be overcome and that there is great potential for New Zealand agribusinesses to get in early and grow with the developing Chinese agricultural sector.

For Chinese investment in New Zealand the issues differ. First, New Zealand is a small market and China is a developing country. China has only recently begun its 'go abroad' strategy and New Zealand companies

are not high on the list of priority investments. Second, the Shanghai Pengxin 'saga' shows that the role of the OIO, interpretation of the Overseas Investment Act and public opinion can make investment in New Zealand a very uncertain venture. Chinese companies struggle to understand how to interpret New Zealand investment regulations, as do many New Zealanders, creating room for uncertainty and political grandstanding. Third, New Zealand businesses have yet to acknowledge China's growing economic role and link with Chinese investors in the same way they have with New Zealand's traditional investment partners. The Synlait case shows a successful joint venture model can bridge this divide and create a win-win situation.

Overall, the speed of the growth of the New Zealand-China economic relationship in terms of trade and government cooperation has left the business community and New Zealand public reeling. They are yet to fully appreciate the opportunities presented by the economic rise of China or to work through the issues inherent in developing investment relations with a new economy and polity that crosses both cultural and developed/developing divides. This creates a series of challenges not found in the trade relationship leading to a lag between the growth of trade and political relations on the one hand and the growth of two-way bilateral investment on the other. The slow increase in two-bilateral investment stock suggests this gap will narrow in future.

Overall, economic integration between China and New Zealand is more complicated than a simple step process where increased trade leads to stronger investment ties. As the global investment statistics show, this is not a situation unique to New Zealand. China and East Asia more generally, have grown their share of economic activity and trade rapidly over the last few decades. The share of outward investment, however, has yet to follow this trend. It is clear that this is beginning to change. The New Zealand case is instructive for monitoring this broader global trend in a small western economy and for identifying the challenges of North-South economic integration in the Asia-Pacific in a post-FTA environment.

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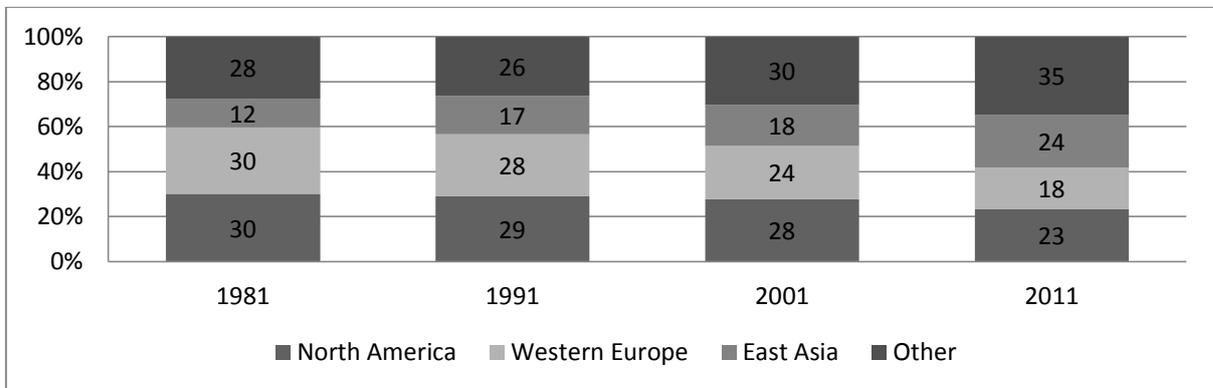
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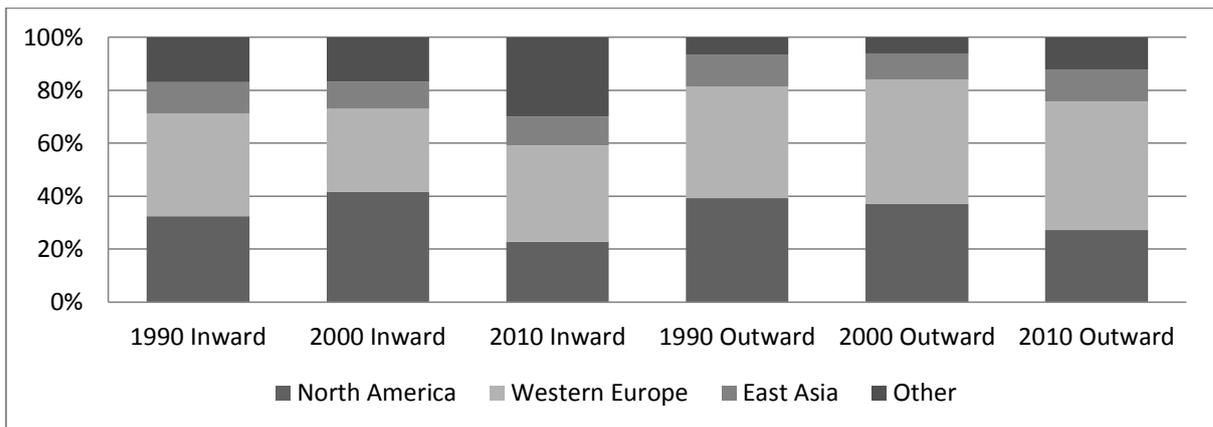
## Appendix 1: New Zealand-China Trade and Investment Data

Figure 1: GDP based on PPP, Share of the World



Source: IMF. 2011. World Economic Outlook (April 2011)<sup>2</sup>

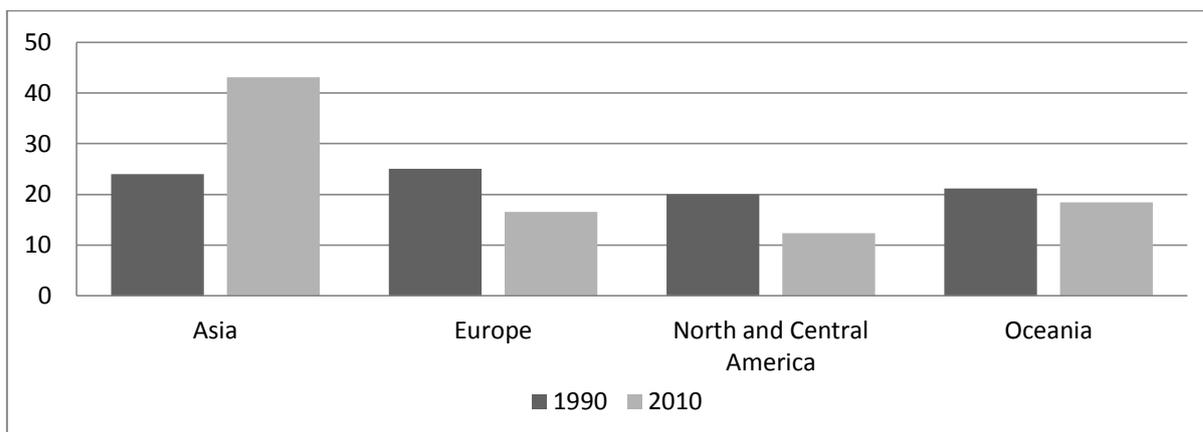
Figure 2: FDI Inward and Outward Stock, Share of World (dollars)



Source: UNCTAD. 2011. World Investment Report

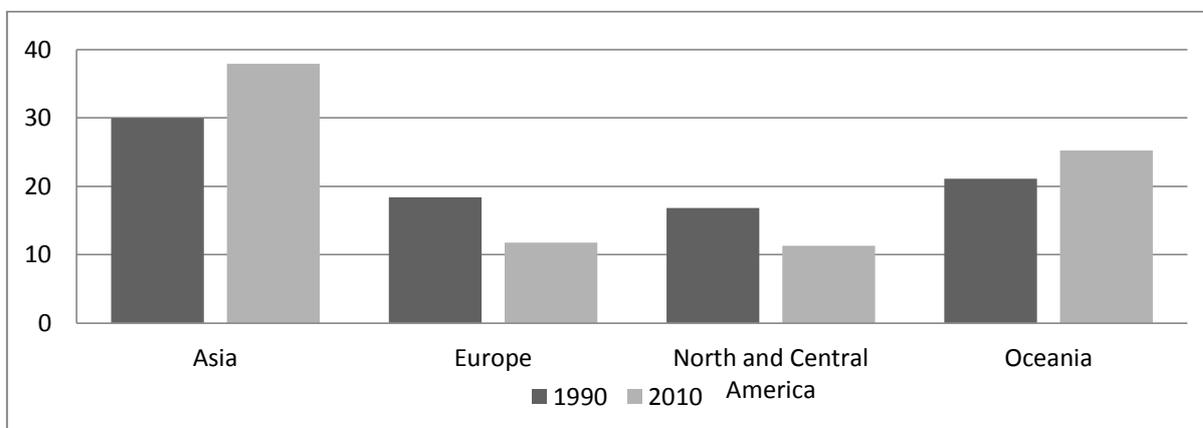
<sup>2</sup>North America: Mexico, United States, Canada. Western Europe: Cyprus, Germany, Denmark, Spain, Finland, France, United Kingdom, Greece, Ireland, Iceland, Italy, Luxembourg, Austria, Belgium, Malta, Netherlands, Norway, Portugal, Sweden, Switzerland. East Asia: Japan, Korea, Mongolia, Taiwan, China, Hong Kong SAR.

Figure 3: Share of New Zealand Merchandise Imports by Region



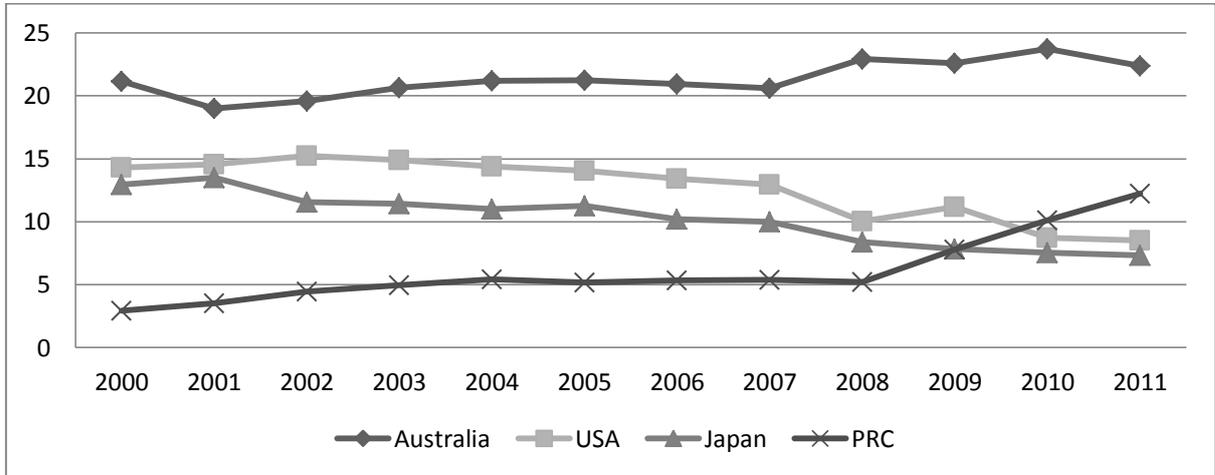
Source: Asian Development Bank. 2011. Key Indicators for Asia and the Pacific

Figure 4: Share of New Zealand Merchandise Exports by Region



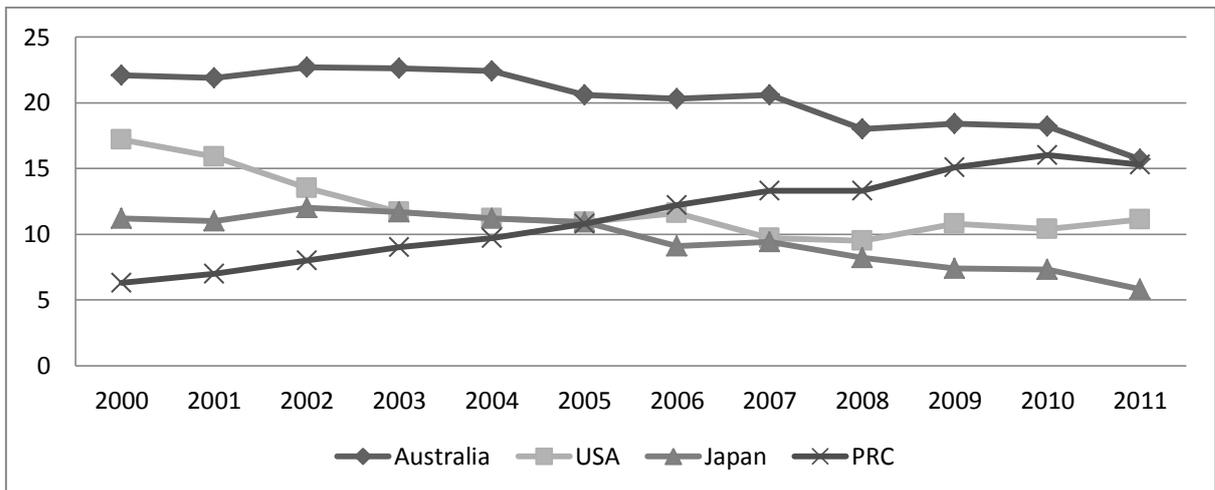
Source: Asian Development Bank. 2011. Key Indicators for Asia and the Pacific

Figure 5: Share of New Zealand Overseas Exports by Country



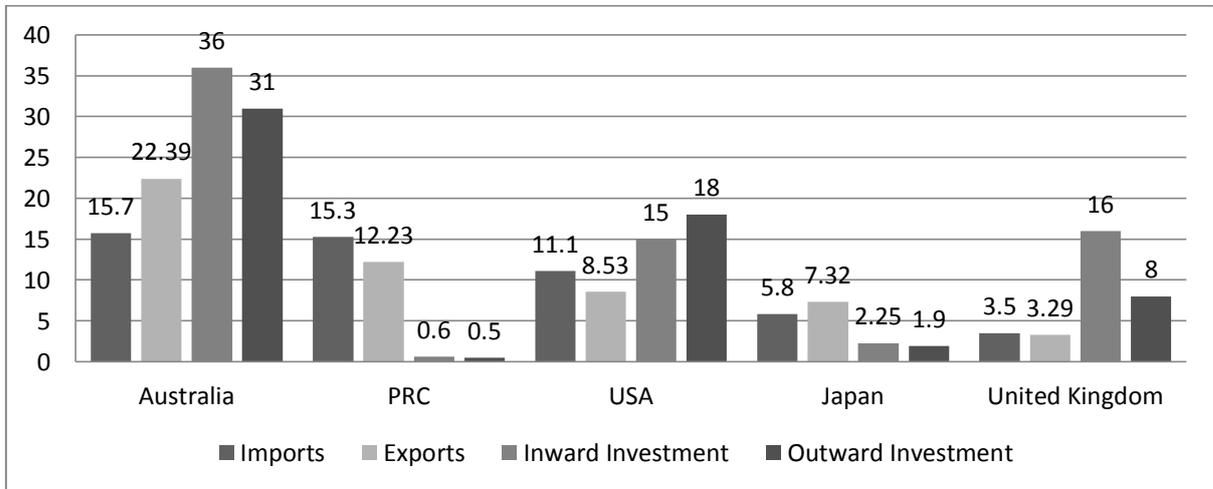
Source: Statistics New Zealand. 2011 year to June

Figure 6: Country Origin of NZ Imports (% share)



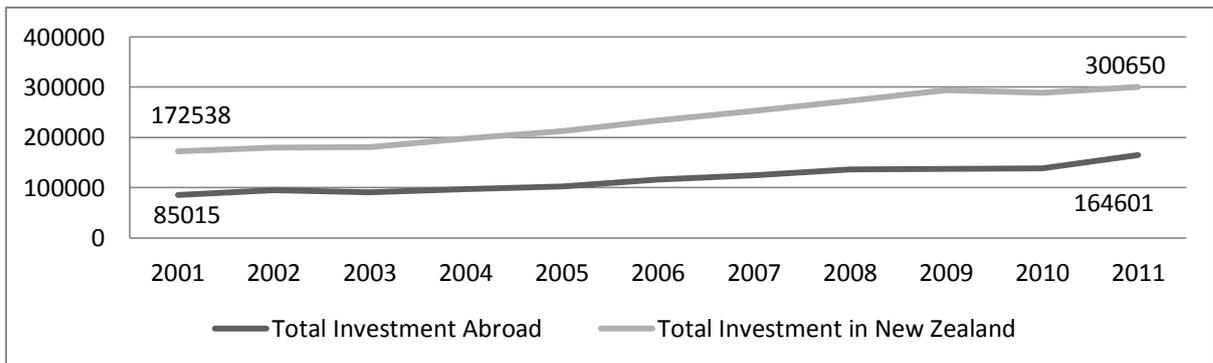
Source: Statistics New Zealand. 2011; 2011 year to June

Figure 7: Trading Partner Comparison of Share of Trade and Total Investment Stock (percentage)



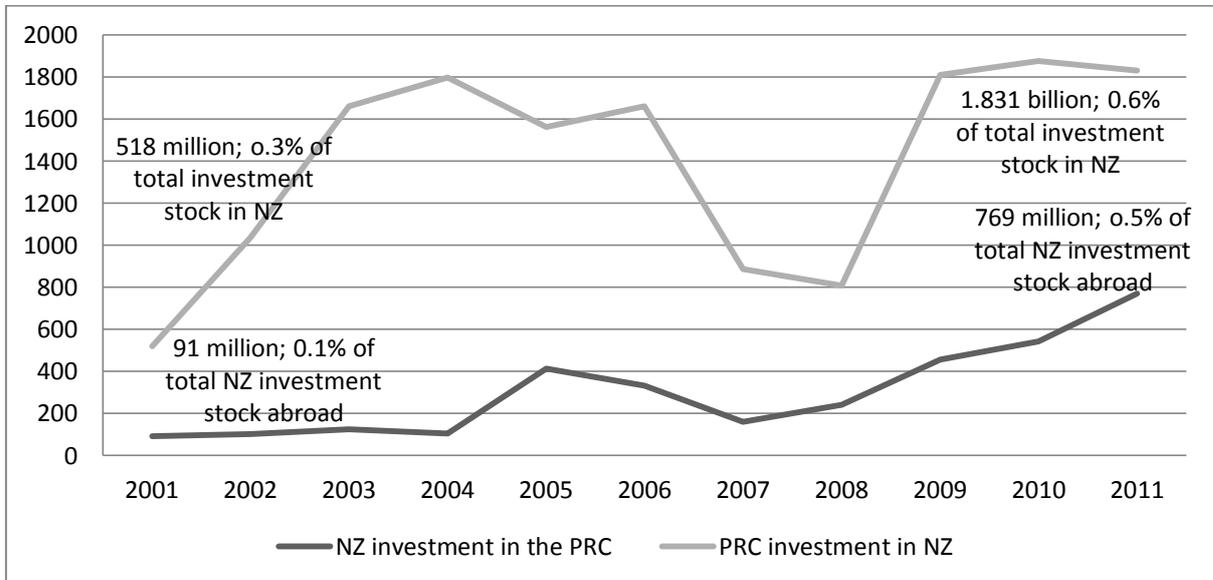
Source: Statistics New Zealand 2011; trade year to June, investment year to March 31

Figure 8: Stock of Total Investment in New Zealand and New Zealand Investment Abroad (millions; NZD)



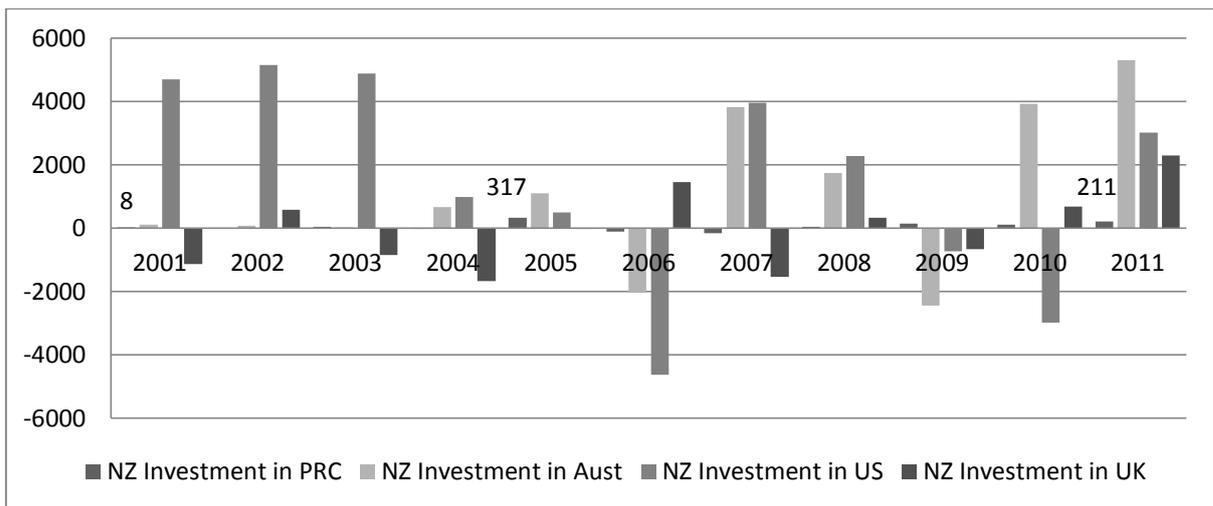
Source: Statistics New Zealand 2011; year end March 31

Figure 9: Stock of PRC Total Investment in New Zealand and New Zealand Total Investment in the PRC (NZD)



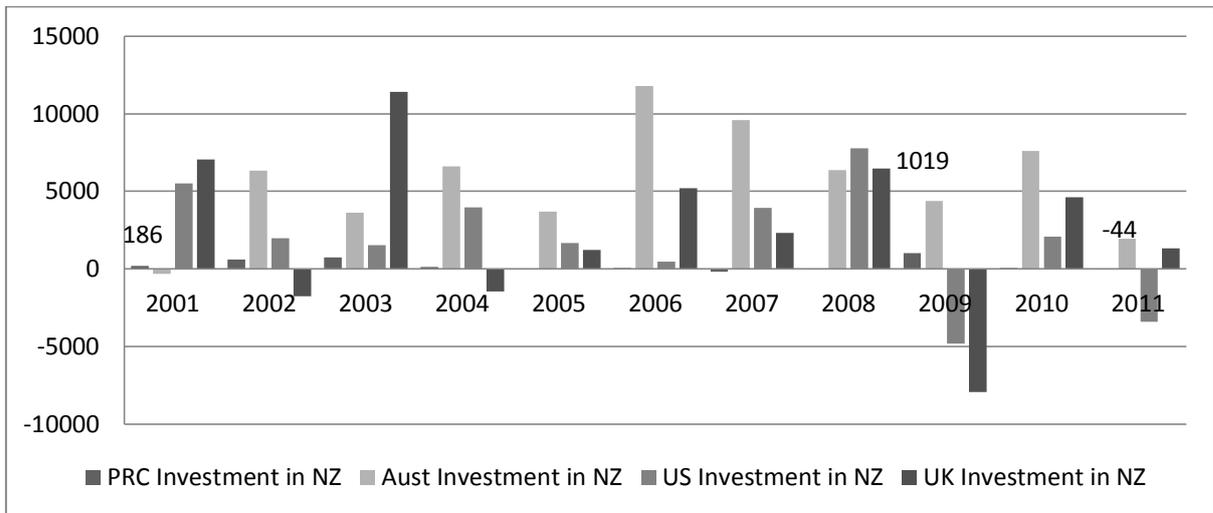
Source: Statistics New Zealand 2011; year end March 31

Figure 10: Flow of New Zealand Outward Total Investment to year end March 31 (millions, NZD)



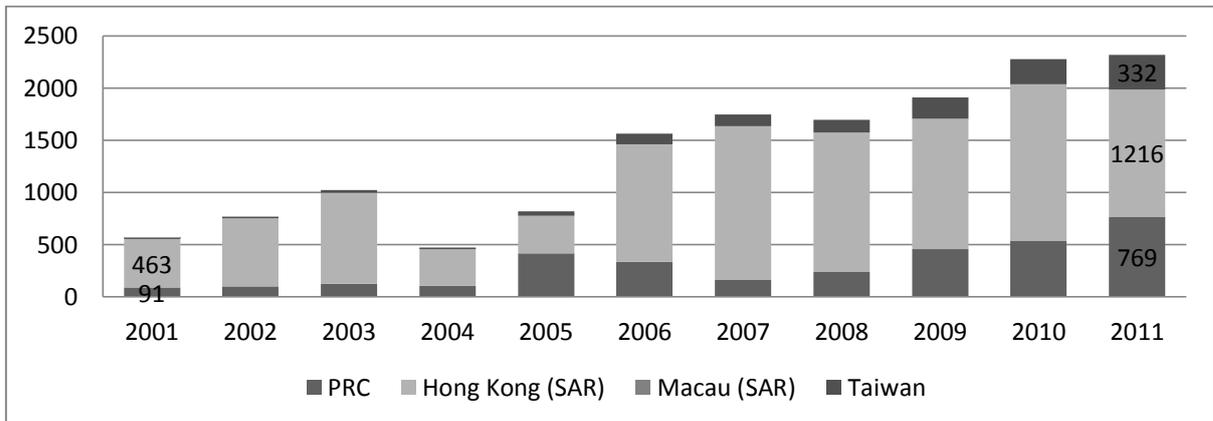
Source: Statistics New Zealand 2011; year end March 31

Figure 11: Flow of Total New Zealand Inward Investment (millions, NZD)



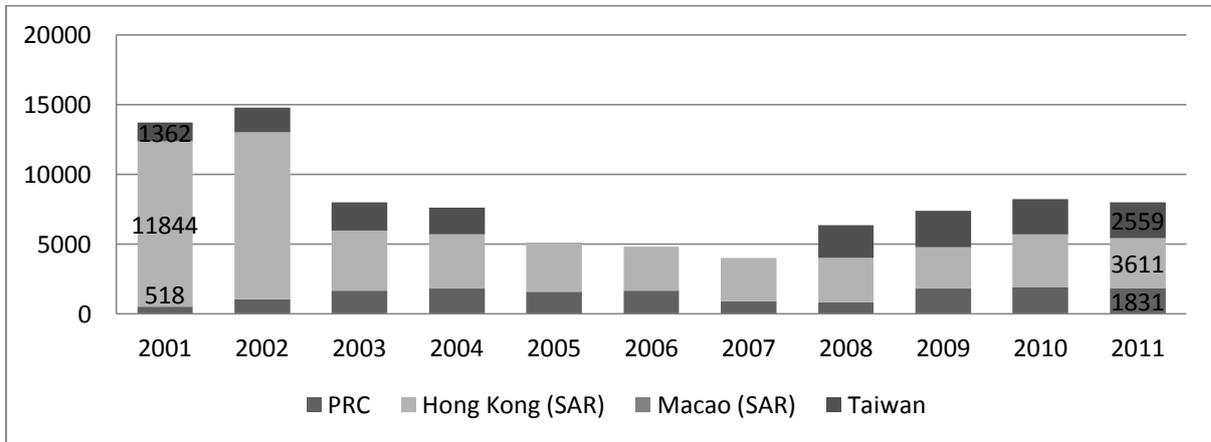
Source: Statistics New Zealand 2011; year end March 31

Figure 12: Stock of New Zealand Total Investment in Greater China (millions, NZD)



Source: Statistics New Zealand 2011; year end March 31

Figure 13: Stock of Total Investment in New Zealand from Greater China (millions, NZD)



Source: Statistics New Zealand 2011; year end March 31; Taiwan no data for '05, '06, '07

## Appendix 2: New Zealand's Preferential Trade Agreements

Table 1: New Zealand's Preferential Trade Agreements

Name of PTA	Effective from
<i>PTAs in Effect</i>	
<b>Australia-New Zealand Closer Economic Relationship</b>	1983
<b>New Zealand-Singapore Closer Economic Partnership</b>	2001
<b>New Zealand-Thailand Closer Economic Partnership</b>	2005
<b>Trans-Pacific Strategic Economic Partnership (P4)</b>	2005
<b>New Zealand-China Free Trade Agreement</b>	2008
<b>ASEAN-Australia-New Zealand Free Trade Agreement</b>	2010
<b>New Zealand-Malaysia Free Trade Agreement</b>	2010
<b>New Zealand-Hong Kong, China Closer Economic Partnership</b>	2011
<i>PTAs under Negotiation</i>	

<b>New Zealand-Australia Closer Economic Relations Investment Protocol</b>	2012 expected
<b>New Zealand-Gulf Cooperation Council Free Trade Agreement</b>	Concluded to sign
<b>Pacific Agreement on Closer Economic Relations (PACER) Plus</b>	
<b>New Zealand-Russia-Belarus-Kazakhstan Free Trade Agreement</b>	
<b>New Zealand-India Free Trade Agreement</b>	
<b>New Zealand-Korea Free Trade Agreement</b>	
<b>Trans-Pacific Strategic Economic Partnership (9 AP countries)</b>	
<b>New Zealand-Hong Kong, Closer Economic Partnership Investment Protocol</b>	
<i>PTAs under Consideration</i>	
<b>New Zealand and Japan</b>	

Source: MFAT (2012), DFAT (2012)

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