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Pacific Island Countries (PICs) and China: Opportunities for Growth and Lessons Learned on Resilience

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I. Introduction

With the rapid growth of Chinese foreign trade and overseas investment, its economic relations with the Pacific island countries (PICs) are also making remarkable progress in recent years. When the global financial crisis has stalled the world major economies, China still maintains impressive growth rates (8% or above). It is reasonable to believe that closer economic ties with China would help buffer the shocks to the PICs brought by the financial crisis, and more than that, may provide opportunities for PICs to build resilience in this difficult time.

Indeed, as a major export market and investor, sustained economic growth in China is of importance to PICs policy makers and businesses. The past high growth of the Chinese GDP is largely attributable to the state-led investment boom. This growth model has enabled China to act as an engine of the world economy, but it has also created economic structural imbalance. The 2008-9 stimulus package the government injected into the economy to fight the global financial crisis has been mostly mis-channeled which only exacerbated the situation. The financial crisis has exposed the flaws of the old growth model to its fullest extent that it leaves the government little room to maneuver but to embrace a new growth model that emphasizes domestic demand and the downsizing of the state-owned sector. To rebalance the Chinese economy has been on the policy agenda of the current government and is expected to be central to the policy platform of the new Chinese leadership which will be ushered in at the 18th Chinese Communist Party Congress to be convened on November 8, 2012.

Against this backdrop, this paper will examine the recent development in economic relations between China and PICs, identify factors that drive the bilateral trade and investment boom, and pinpoint specific areas of strategic importance for PICs in expanding their economic cooperation with China.

The paper is organized as follows. In Section II, the paper reviews China's past development strategy, evaluate the government's response to the 2008 financial crisis, and elaborate the prospects of new growth model. Particular reference will be given to policy development in the areas of energy, food security and poverty alleviation, and their implications for PICs. Section III examines the bilateral economic relations with an aim to enhance trade and investment linkages and broader South-South economic cooperation between the PICs and China. Section IV focuses on lessons learned on policies to build resilience against a wide range of shocks, including major

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economic crises, food and energy insecurity and natural disasters that could be shared by China with PICs. Section V concludes.

II. China's growth model and implication for PICs

China's Growth Model

From a historical perspective, China has a super stable social and political system and lacks a mechanism to generate fundamental change or reform from within. When changes do occur from within, it is to avoid or respond to immediate crises. From 1949 – 1976, the country adopted a comparative advantage defying development strategy, resulting in highly distorted economic structure. The economic reform that started in 1997 was a response to political and economic crises that ended the Cultural Revolution in 1976, as the national economy at that time was "at the brink of collapse," according to official assessment. The first shot of reform was fired by peasants in Fuyang, Anhui Province. Out of desperation, peasants disbanded the rural commune and distributed land to household, an illegal act but tolerated by the government. Official thinking at that time was that the situation of the rural economy was so bad that it could not be worse no matter what the peasants did! It turned out, however, that the experiment was a great success and subsequently accepted and promoted nationwide by the government. It also inspired the urban reform and similar responsibility system was instituted to reform the Chinese industry which was dominated by the state-owned enterprises (SOEs). The nature of the reform from the late 1970s to the late 1980s in both agriculture and industry was to encourage the establishment of private and rural business or to discipline or even privatize SOEs. Given that official ideology of the Chinese Communist Party is pro public (or state) ownership, it was unusual that the first wave of reform went ahead without much political opposition, thanks to the blessing of the paramount leader Deng Xiaoping. In the sense that it corrected the distortions created during China's early industrialization under central planning, the first wave of reform was a genuine one.

The 1989 Tiananmen incident was a turning point. The new leadership that took office after June 1989 installed austerity program, which was meant to clean up the mess left by the previous reform program and at the same time, introduced no new reform initiatives and even attempted to revert back to central planning. China's reform was at its cross road in the early 1990s. It was Deng Xiaoping's South Tour in January 1992 and his series of speeches during the tour that brought the Party back to the track of "reform and opening up" with his famous slogan "Development is the overriding principle." This set off a second wave of reform which runs through the past two decades under the leadership of Jiang Zemin and Hu Jintao. But unlike the reform in the 1980s, the new initiatives since the early 1990s have moved away from fostering the non-state sector and rural economy towards more politically correct direction: strengthening the state sector.

Instead of continuing to promote private sector and the rural economy, the new leadership under Jiang Zemin took on SOEs adopting a strategy to "keep the big ones and let go the small ones," i.e., to privatize the small and money losing SOEs and keep and convert the large ones into modern corporate enterprises. The SOEs consolidation came with a set of industry and competition policies that helped consolidate SOEs' monopolies in key sector, such as auto, telecom, banking and oil, etc. It also came with cheap bank loans. All these policies and preferential access to resources constituted subsidies paid by the non-state sector, households,

private business and the rural economies. This development strategy to foster strong SOEs in capital intensive sectors left the private and mostly labor intensive sectors in bad need of capital, which opened the door for foreign investors to take advantage of China's abundant labor in exporting sectors. It was since the early 1990s that FDI inflows and exports started to soar.

Also contributing to the surge of FDI inflow and exports is the system put in place by the central government to evaluate and promote local officials. High on the list of criteria for performance evaluation are these two indicators and GDP, among others. This incentive scheme motivates local governments to build industrial parks for FDI and other infrastructure on the land taken from peasants with compensation often lower than the land's industrial value. FDI is asked to produce goods for exports to avoid competition with local firms, unless it brings in technology and shares with SOEs in an equity joint venture. Under this model, investment (both domestic and FDI) and exports are the main engines of China's growth, with a relatively weak domestic consumption. The weak domestic consumption is due to high household savings as a precaution for health care, child education and retirement, etc., and also a result of the development strategy biased towards capital intensive projects which depress labor income.

This growth model continued into the terms of Hu Jintao (current Party Secretary General) and Wen Jiabao (current Prime Minister), with even stronger push for SOEs and a new initiative of housing reform. The commercial housing program allows the local government to take more land from peasants with low compensation and auction them to developers at market prices. The alliance between the local governments and developers has led to the boom of property market and rising housing price. This helps boost investment demand, raise much needed revenues for the local government, and enrich the developers. However, it also further squeezes the household disposable income as generations of savings are put to purchase a highly expensive apartment.

The growth model since early 1990s is different from that in the 1980s. While it has generated high GDP numbers, it also created rural and urban divide, coastal and inland divide and environmental deterioration. The economic growth heavily depends on state-led investment and exports. The 4 trillion yuan stimulus package, the government initial response to the 2008 financial crisis, was mostly handed to SOEs who chose not to invest in manufacturing as it already has over-capacity in production and weak demand, but bet the money in the property market. The government rescue only made the economy afloat for a short period of time, but generated long lasting negative impact such as soaring property prices, inflation pressure and even more bloated SOEs. With the deepening of the financial crisis, the only way out is economic restructuring with an aim to boosting domestic consumption. The task lies on the shoulder of the next generation of leadership to be elected in the coming 18th Party Congress in November 2012.

Energy, Food Security and Poverty Alleviation

China's growth model in the past two decades is characterized by state-led investment boom with SOEs as a vehicle. Since many of the investment projects are in infrastructure and real estate sectors that requires a very high dose of energy or energy-intensive materials (such as steel and cement), China has become a key importer of oil and coke, and is believe to be a driving force of energy price in international market. On the other hand, lack of energy tax and low energy price at home which is traditionally set to fuel the industrialization drive, have left Chinese firms little

incentive to improve their energy efficiency. Therefore, growth or fluctuation of the Chinese economy will have an impact on energy price in world market.

The problem of heavy reliance on imported fuels, resource depletion and environmental deterioration at home has alarmed the government. In the early years of the Hu and Wen terms, new thinking on the development strategy was proposed under the name "Scientific Outlook," which aims for sustainable and balanced economic development. With this development philosophy instituted into the Party platform, to achieve sustainable energy use has become part of the long term overall program of economic transformation. As a result, the focus of the energy policy has been shifting towards promoting clean energy and energy efficiency, and a possible introduction of resource tax. When the government revealed its 4 trillion yuan stimulus package in early 2009 to boost domestic demand, the clean energy sector was a top recipient of the fund.

For a country with a 1.3 billion population, food security is of great importance. The great famine in the 1958-60 and the embargo imposed by the UN in the early years of the communist regime have left bitter memories for the government. As a result, food security has become the cornerstone of the country's agricultural policy. Food security is a very legitimate concern for any country. But for China, it means the 95% grain self-sufficiency. This interpretation of food security has serious implication for China's international economic relations, in both multilateral and regional trade relations. Under this policy, 95% of domestic grain consumption has to be produced in China, and grain imports are subject to tariffs rate quotas (TRQs). As an arable land scarce country, China does not have a comparative advantage in grain production, and to meet the 95% grain production target has resulted in overuse of farm chemicals that damages the rural environment. It also hampers the poverty reduction efforts as grain growers normally do not earn a good income. In comparison, China's strategy for energy security focuses on securing access to international supply, rather than domestic production despite of recent push for the development of renewable energy. In this regard, two of China's national security goals reflect the policy makers' conflicting mentalities on international trade: one pro import restriction as a precaution for an embargo scenario, and the other pro open trade assuming undisrupted international commerce.

Despite the grain policy, China is a success story for poverty alleviation. Since the early 1990s, export oriented FDI in China's coastal region has attracted millions of migrant workers from poor inland to work in assembly lines. The gradual but eventual phase out of the Multi-Fiber Arrangement between 2001 and 2006 gave an unprecedented expansion of China's textile and clothing sector, which helped buffer the shocks of agricultural trade liberalization associated with China's accession to the WTO in 2001.

China is a major cotton importer in the world market. Under its WTO accession protocol, China has TRQs for cotton that could effectively protect Chinese cotton growers. However, in anticipation for the expansion of its textile and clothing sector and the resulting increase in employment in this sector, the government decided to liberalize cotton imports shortly after China's WTO accession. In recent year, economic and social stability in China's major cotton growing region, the Xinjiang Uighur autonomous region, has become a concern for the government and support program for cotton production has been reinstated. But it does not reverse or even moderate the trend of soaring cotton imports.

Needless to say, there are still quite a few poverty pockets in the vast Chinese region. The economic development has lifted millions out of poverty. But China could have done better if the current growth model were not overly biased in favor of urban state sector.

Implications for PICs

China is important for PICs as a trading partner, investor and donor. The much anticipated adjustment of China's growth model amid global financial crisis and leadership transition would have an impact on its foreign economic relations. On energy and food security as well as poverty reduction, PICs could draw lessons from China's past experience.

Like China, PICs are net energy importers but with a much more fragile environment. Therefore, to avoid energy-intensive industry and encourage the use of clean and sustainable energy should be the general strategy. The slowdown of the world economy and the structural adjustment in China will reduce the energy demand and therefore lower the energy price. This will provide a breathing space for PICs to build their resilience to weather the energy price volatility.

China does not have a comparative advantage in grain production. Nor do PICs. China's emphasis on grain self-sufficiency is very costly and has environmental ramifications, and should not be followed by PICs. As argued by Amartya Sen, the ultimate food security is the entitlement to food, rather than food supply itself. In this regard, to raise the income of the poor and to improve food supply and distribution should be the focus of PICs policy makers.

As a large country, China's poverty reduction has relied on economic development and its integration into the world economy. This should also be the ultimate solution for PICs, though in the short term, foreign aid could produce immediate results.

In the next two sections, this paper will examine in details the bilateral economic relations and offer specific suggestions to build resilience for PICs.

III Opportunities presented by rapidly growing Chinese markets

China – PICs trade relations

China's trade relations with PICs are imbalanced. China exports a variety of manufactured goods to PICs, but only imports fish and other sea products (see Table 1). Bilateral trade balance is in China's favor. The patterns of bilateral trade are not a surprise, given that PICs are characterized by their small size and remoteness, and the associated narrow export base.

Table 1 provides data on Chinese official data on its imports from PICs over the past ten years. While imports include only fish and other sea products and the volume was small at beginning, it has grown dramatically especially in recent years after the global financial crisis, which in 2010 is 25 times bigger than that in 2002. The surge of Chinese imports from PICs could contribute to several reasons. First, in terms of the overall trend, Chinese consumers are getting richer and demand for diverse and healthy diet is on rise. This has led to the surge of soybean imports in the past decade. Domestic food safety incidents have turned health conscious consumers to imported food, including sea food. The second reason could trade diversion, as recession has hit harder

other parts of the world and PICs turns to China for export opportunities. The third reason could be China's tariff reduction as a result of its WTO accession (down from 13% to below 10% for imports from PICs), and zero tariff treatment (effective since 2011) granted to Vanuatu and Samoa, the only two LDCs with diplomatic ties with China in PICs. According to the Chinese data, Marshall Islands are the largest exporter to China (US$16 million), followed by Solomon Islands, Vanuatu and PNG.

However, the data does not include bilateral services trade. Presence of Chinese financial institutions is very visible and more Chinese tourists are coming to PICs. This is a vibrant area of bilateral trade development.

China's FDI in PICs

Table 2 present data on China's FDI in PICs, which shows a dramatic increase in the overall number from US$35 million in 2006 to US$240 million in 2007. This is partly due to the change in the methodology to compile the statistics: in 2007, the data starts to include financial FDI, e.g, investment to set up overseas branches of Chinese banks. But there are also real new investment projects in recent years, including the Ramu nickel and cobalt mine project in PNG, solar energy projects in Samoa and highway, hotel and e-government projects in Fiji. These projects made the three countries among the top recipients of Chinese investment in 2010 in terms of FDI stock. For Marshall Is, the authors do not have information on the nature of the Chinese investment, but would consider the possibility that Chinese companies registered there as local ones and came back to China as a foreign investor to take advantage of Chinese preferential policies towards foreign investors.

Potentials to expand trade and FDI

Chinese tariffs on PICs fishery are around 10% and still have room to be reduced. Unlike grain and autos that are politically sensitive to China, opening up to PICs fishery exports is a feasible policy option.

Among the five countries that qualify for zero tariffs for LDCs (Samoa, Vanuatu, Kiribati, Tuvalu and Solomon Islands), only two (Vanuatu and Samoa) actually received the treatment. The other three are excluded because they have diplomatic relations with Taiwan instead of mainland China. The rivalry between mainland China and Taiwan for diplomatic recognition by PICs has been a long story, but recent improvement in the cross strait relationship has led to the Economic Cooperation Framework Agreement (ECFA) that will gradually liberalize trade and investment between mainland China and Taiwan. In light of this positive development, it is high time to explore the possibility that mainland China and Taiwan both grant preferential market access to non-diplomatic least developed PICs allies out of humanitarian considerations.

Besides tariffs, non-tariff measures (NTMs) could be hurdles for PICs exports to China. Regulations and rules on China's NTMs are issued and enforced by various agencies and they are scattered at various government websites. Recently, the World Bank, UNCTAD and African Development Bank have commissioned one of the authors (Shunli Yao) to identify and collect China's NTMs according to the new NTMs classification developed by a multi-agency task force. This work has been done and it will for the first time provide China NTMs information at product

level to the public through the UNCTAD TRAINS database. Given that PICs export mostly fishery products to China, there are many TBT and SPS measures applicable to them. To improve the compliance capacity with these NTMs would help with PICs' access to the Chinese market, and this in turn would require a good understanding of the nature of the relevant NTMs. To use this new database to do a study on PICs exports and China's NTMs would be a good start.

The expected economic transformation in China, if successful, would help increase the household income. With more disposable income, China's middle class would consume more healthy and high quality imported food, which will continue and accelerate the process of PICs fishery exports to China. They will also make more and farther trips to explore the natural wonders of PICs. This in turn will drive more investment in finance and tourism in PICs to better serve the Chinese tourists and businesses, the development which is ongoing.

However, economic restructuring in China also calls for a smaller state sector and will liberalize the sectors traditionally monopolized by SOEs. This will reduce the profitability of SOEs at home and therefore limit their ability to invest in riskier overseas markets. SOEs investment in infrastructure, resource and clean energy sectors would be negatively affected based on the logic of economics. However, China's relations with PICs have dimensions other than economics. Since PICs are small and Chinese investment could well be motivated by geopolitical considerations, the economic logic may not apply to China's FDI in PICs.

In terms of broader South-South economic cooperation, China has a long tradition to aid other developing, especially the least developing countries. The program to offer zero tariffs for LDCs, as mentioned above, is an example. More recently, visit to Fiji by Wu Bangguo, Chairman of China's National People's Congress, has produced an agreement under which China will provide F$200 million loan to Fiji. In PICs, there are numerous Chinese projects to build schools and hospitals, to provide assistance in agriculture, and to bring students to study in China.

Section 2: Lessons learned on policies to build resilience

China's response to global financial crisis

China's growth mode in the past two decade has been characterized with state-led investment, dependence on export markets and weak domestic demand. Prior to the outbreak of global financial crisis in 2008, debate was going on regarding the sustainability of the growth model, as it generated over capacity in production. However, lack of political will to overcome the opposition of SOEs made the government move very slowly in changing the growth model. The financial crisis was a good opportunity to push for the much needed reform. However, instead of undergoing structural change, the government opted to put forth the huge stimulus package (4 trillion yuan). Because of over-capacity in production and weak demand at both home and overseas markets, the stimulus money was divert to the property market that pushed the housing price even higher in the recession. It has only limited impact on growth, but left with monetary overhang and inflation pressure. Opportunity was lost in 2008 for China to carry out much needed structural reform. The stimulus package has only exacerbated the imbalance of the economy and left little room for any further monetary expansion to fight the recession. In this regard, China's stimulus package was really not really stimulating and sustainable. The new

leadership who will take office following the 18th Party Congress will have no other choice but to reform the growth model.

Energy Policy

Clean energy program has been there for a long time, but China started the bold program to build its renewable energy sector just only under the Hu and Wen leadership starting in 2002. This program come huge government support in terms of subsidies and easy access to loans. It is very politically correct speak about clean energy and sustainable development. This sector received its fair share of fund from the stimulus package. The boom of China clean energy sector has created many trade disputes with the US and EU because of low prices of the Chinese energy products, such as solar panels. However, clean and renewable energy is the key part of China's sustainable development strategy, it is unlikely the sector would be negatively affected in SOEs restructuring in the foreseeable future. Given the precious and fragile environment and unique geography in PICs and their dependence on imported fuels, to work with China to develop clean and renewable projects is a policy option to be pursued by PICs.

China has a tax revenue sharing scheme between Central and local governments, with a strong position at the national level and a weak position of the localities. While at the national level, development planning is made every five year with the backing of national budget and the state-owned banks, the difficulties of translating the targets into concrete outcomes lie in the inefficient implementation and inadequate project quality supervision, especially at local level. This applies to China's clean and renewable energy program.

Food Security

This is a very legitimate concern, but China's grain-self sufficiency is not an option for PICs, as far as environment is concerned.

Textile and clothing industry

China is a big exporter of textile and clothing products and also a big importer of cotton. Since China's accession to the WTO, its net cotton imports have been growing rapidly (Table 3). This has a lesson for PICs' textile and clothing sector: it has to rely on design unique to local culture rather than price to compete or even to survive.

Freight

PICs international trade is sensitive to the freight cost. One good aspect of the global financial crisis is the fall of freight cost (Figure 1). During the past two decades, China has built a large fleet of cargo ships and the financial crisis has left them much idle capacity, which could be used to help with the marine transportation which is crucial for PICs' comparative advantage sectors to be fully exploited. It is high time for PICs to get COSCO involved in expanding PICs shipping capacity.

Appendix 1: List of Pacific Islands countries

The coverage of the Pacific Islands countries (PICs) would be "all ESCAP member states and associate members" in the Pacific sub-region.

ESCAP Member States are:

Fiji
Kiribati
Marshall Islands (the)
Micronesia (Federated States of)
Nauru
Palau
Papua New Guinea
Samoa
Solomon Islands
Tonga
Tuvalu
Vanuatu

ESCAP associate members are:

American Samoa
Cook Islands (the)
French Polynesia
Guam
New Caledonia
Niue
Northern Mariana Islands (the)

Appendix 2: Tables and Figure

Table 1: Chinese Imports from PICs, in US$1,000

PICs	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Cook Is	25	53	65	5,419	1,190	1,824	1,599	246	1,149	731
Fiji	1,091	405	1,609	1,852	656	2,011	695	2	47	477
Micronesia						45		3,923	2,742	1,554
Marshall Is		36			194	26		11,852	5,204	16,506
New Caledonia			18	40	73					
Palau						1				
PNG			59			57	13		2,175	2,010
Fr Polynesia			614		992	643	2,130	1,962		
Solomon Is							1,676	2,204	3,839	2,336
Vanuatu			1		1,024	307	308	1,210		2,174
TOTAL	**1,116**	**493**	**2,366**	**7,311**	**4,129**	**4,915**	**6,422**	**21,399**	**15,157**	**25,788**

Source: COMTRADE

Note: all imports fall into the category of "HS2=03, Fish & crustacean, mollusc & other"

Table 2. China's FDI flows and stock in PICs, in million US dollars

	FDI Flow							
PICs	2003	2004	2005	2006	2007	2008	2009	2010
Fiji			0.25	4.65	2.49	7.97	2.40	5.57
Marshall Is				2.00	34.16	8.00	26.70	13.18
Micronesia			0.12		6.25	-0.16		
Palau					0.50	7.52		0.50
PNG		0.10	5.88	28.62	196.81	29.92	4.80	5.33
Samoa	0.42				-0.12		0.63	98.93
Solomon Is								
Tonga								
Vanuatu								
Oth.Ocean.Nes								
TOTAL	**0.42**	**0.10**	**6.25**	**35.27**	**240.09**	**53.25**	**34.53**	**123.51**

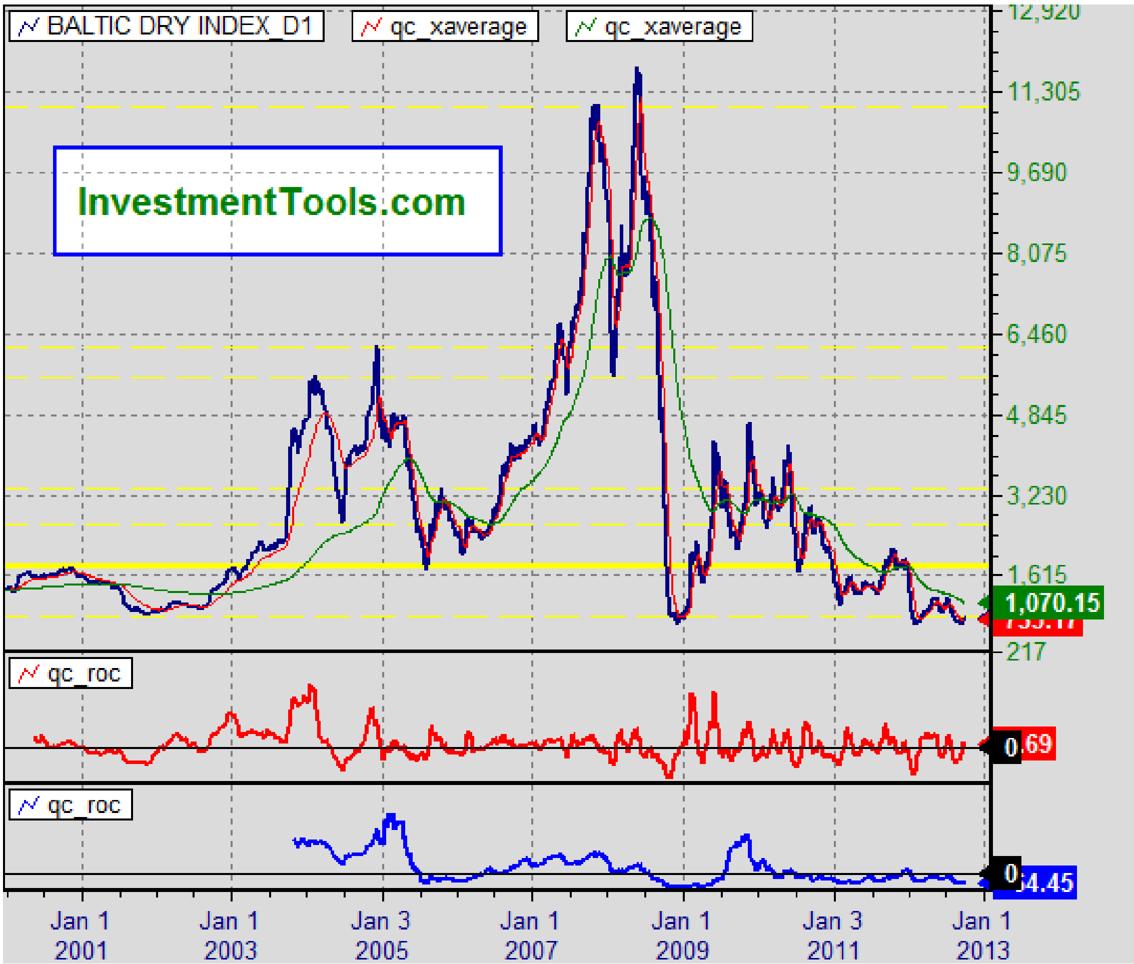
Source: China Outward FDI Statistical Bulletin 2010

Note: Data for 2003-2006 include only non-financial outward FDI flows.

Table 3. Cotton Trade Balance
(in million US dollars and 1,000 tons)

	Trade Balance	
Year	Value	Quantity
1992	-238	-146
1993	176	139
1994	-764	-415
1995	-1,371	-739
1996	-1,248	-680
1997	-1,390	-781
1998	-301	-164
1999	204	186
2000	224	240
2001	5	-7
2002	-16	-27
2003	-1,035	-761
2004	-3,160	-1,898
2005	-3,189	-2,567
2006	-4,845	-3,629
2007	-3,446	-2,438
2008	-3,458	-2,095
2009	-2,097	-1,518
2010	-5,647	-2,830
2011	-9,390	-3,338

Figure 1. Baltic Dry Index: Historical Trend



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