Agricultural Economy and Policy Report - China **February 2009**

Political

The Communist Party remains in firm control of China's government. Nearly thirty years ago, the Party embarked on a series of reforms designed to move China from a centrally planned to a market-based economy. While the prosperity accompanying this transformation has helped to maintain popular support for one-party rule, the uneven development of the last thirty years has also brought about a number of social problems. More than 80,000 protests were reported in 2005, the latest reported information available, indicating that civil unrest as a result of corruption, land confiscation, rural poverty and environmental problems, among other issues, leave China's leadership deeply concerned about social stability. Any significant slowdown in economic growth could exacerbate these problems. The current leadership, President Hu Jintao and Premier Wen Jiabao, have been in office since March 2003.

Economic

Over the last quarter century, China's economy has evolved from a centrally planned system mostly closed to international trade to a rapidly growing market-oriented economy that is the most important player in the global economy. Beginning with the phasing out of collectivized agriculture, China's reforms have included price liberalization, fiscal decentralization, increased autonomy for state enterprises, the development of a diversified banking system, and stock markets. As a result of these reforms, the rapid growth of the private sector, and the opening to foreign trade and investment, China has experienced unprecedented economic growth of between 8 and 12 percent per year. This growth has lifted an estimated 200 million people into the middle class and transformed the economy and consumption patterns. China joined the World Trade Organization (WTO) in December 2001, further boosting GDP growth, direct foreign investment, and exports. Although 75 percent of China's economic growth comes from domestic sources, its tradition of export-oriented growth has given it foreign exchange reserves of more than $1.3 trillion. Some farming sectors have begun to organize as supply cooperatives to guarantee better prices and collective standards. These cooperatives are becoming farmers advocate groups that will have the power to influence national and provincial policies.

Despite these enormous changes, the incomes of the rural population have fallen behind, creating a sharp divide between China's urban and rural residents. With nearly 60 percent of China's 1.3 billion people living in the countryside, the rural/urban income gap is a major concern for the Chinese government. Although rural incomes have improved significantly over the last 30 years and starvation has been mostly eliminated and malnutrition limited, average per capita rural incomes are still only $350 per year.

China faces other significant challenges. Foreign pressure over China's trade surplus and undervalued currency has lead to a steady increase in the value of the Yuan (Renminbi), a development that could slow export growth. In addition, concerns over the impact of an economic slowdown have led the Chinese government to direct banks to restrict loans and increase interest rates to help prevent the economy from overheating. However, a more restrictive monetary policy could contribute to not only a domestic but also a global economic slowdown. In addition, China faces challenges including restructuring its inefficient state-owned-enterprise sector while continuing to provide an effective social safety net to prevent domestic instability as the Communist welfare state continues to dissolve. Other priorities include ensuring an adequate and sufficient energy supply, a constant challenge compounded by recent droughts and the rapid expansion of China's urban areas, many of which already suffer frequent energy shortages.

China is undergoing the largest internal migration in human history. With industrial development as the driving force behind economic growth and the relative poverty of rural communities, migrant workers are also becoming a significant issue. Migrants are untracked but estimated at between 100 and 150 million people. Off-farm income generated by these migrant workers—predominately farmers—ensures greater income flows back to the countryside. The official number for rural to urban migration has been 1.5 percent over the last 10 years and is expected to continue requiring China's already overpopulated cities to accommodate another 200 million low-income workers over the next five years. As a result, some projections forecast the rural population to drop to 20 percent of the total by 2027.

During 2007, China's leaders have focused increasingly on maintaining a "harmonious society" unsettled by the increasingly unequal income distribution, rising environmental problems, and the mass migration from rural areas to cities. In particular, the China's leadership is increasingly concerned about raising rural incomes of roughly 800 million peasants through agricultural modernization. Despite this, overall public investment in the rural sector is only around 7 percent compared to the national average of 11 percent for the urban sector. The majority of public investment projects in the rural sector focus on providing basic infrastructure development and not yet on small business development and job creation.

<u>Inflation</u>
Another major concern for China's government is the sudden and precipitous increase in retail prices for staple consumer goods during each month of 2007. These increases are mostly attributed to inflation due to rising incomes and overall increases in consumption and demand for food products due to the rising GDP. However, the decrease in farmland and shortage of food has also impacted inflation. China reached its highest inflation rate of 6.5 percent in both August and October 2007 which was its highest inflation in 11 years. Food prices are rising rapidly and were up 18 percent in October 2007 from a year earlier. China's swine herd suffered from an outbreak of Porcine Reproductive and Respiratory Syndrome (PRRS) in May 2007 which caused a loss of 10 million pigs. As a result, pork prices in 2007 soared to 50 percent above 2006 levels.

Official data shows that although for the last three consecutive years grain production in China has risen, rice and wheat prices have seen significant increases. Similarly, corn prices have increased as a result of low yields because of drought. The decrease in corn production in China has impacted the world corn supply and prices. Corn has been diverted into the ethanol and biofuel industry while increased demand in the livestock sector and expanded industrial use have also put pressure on domestic corn supplies, resulting in higher prices. These and other food price increases are mostly a result of China's double digit economic growth rates. The accompanying growth in consumption has fueled the rise in retail food prices and squeezed domestic supplies creating a market for higher valued and imported goods.

The trend of rising retail food prices is forecast to continue in step with China's growing economy. Any significant shortfall in China's domestic grain production would impact China and global food prices.

General Trade
China has a huge domestic market, expanding as disposable incomes rise. In addition, it is a trade powerhouse. In 2006, China's exports exceeded $969.3 billion and imports rose to nearly $791.8 billion, increasing 27 percent and 20 percent respectively. China's

top trading partners are the EU-27, the United States, and Japan, with each accounting for about 15 percent of total trade. The United States remains by far China's largest export market. In 2006, U.S. trade figures recorded a bilateral trade deficit with China of $232.5 billion, a 15 percent increase over 2005 and source of continuing political concern for both countries. U.S. imports from China were $287.7 billion in 2006 (an increase of 18 percent), making China the second largest exporter to the United States, behind Canada at $303.4 billion.

Agricultural Production

China is the world's largest agricultural producer in terms of volume (the United States is the world's largest producer in terms of value). Traditionally agricultural production has been focused on food security and rural social stability. An outgrowth of these two objectives was grain and oilseed self-sufficiency and limitations on rural to urban migration (the *hukou* system). With less than 7 percent of the world's arable land to support almost 25 percent of the world's population, in 2000, self-sufficiency in oilseeds gave way to China becoming the largest importer of soybeans in the world, topping $2.6 billion from the United States alone. China is dependent on imports to cover more than half its soybean needs, which also supply extensive crushing and refining sectors.

Self-sufficiency in food grains (including corn) remains a reality. Most arable land is still devoted to growing primary grains such as corn, wheat, soybeans, and rice. International trading firms have entered the feed sectors, importing soybeans, but state trading enterprises or quasi-government organizations dominate these sectors. While a number of institutions from the era of a centrally planned economy remain, after more than 20 years of reform, other agricultural sectors are principally market driven. Consistent with the low cost of labor, production is fragmented and labor-intensive with the average farm size just over one acre.

Areas near the cities have also seen shifts to produce higher-value crops or livestock. Production of fruits and vegetables has doubled over the past ten years. Rising incomes in the general population have fueled steady growth in the livestock sector, particularly swine, poultry, aquaculture, and dairy production. This growth has also led to increased demand for animal feed and protein sources, driving up prices for both corn and soybeans. Investment in agricultural production has led to high-profile successes in apple products, garlic, and a limited selection of processed vegetable products. Cotton demand has also boomed alongside the textile sector, and recent changes in global textile trade rules should only further benefit China's producers.

Investment in Agriculture

Government spending on agricultural production is diverse and not easily quantified. Public investment in China's agriculture is focused on broad-based assistance with a social component and is coordinated with provincial government assistance and (high risk) bank loans. While small at the farm-level, aggregate public support for programs ranging from seed support to investment in farm machinery is in the billions of dollars.

Private sector investment in China's agriculture is in the production and processing of livestock, fruits and vegetables, and other high-value commodities. As mentioned above, foreign companies with investments in China, including some agribusinesses, are responsible for half of all foreign trade. Investment in textile mills is also substantial. Ongoing investment will continue to enhance China's ability to compete in the trade of high-value, labor-intensive agricultural products.

China's domestic products could compete with and displace U.S. products, particularly in the Asian markets closest to China. Barring major policy changes in China, with limited arable land and self-sufficiency commitments, this competition is likely to be limited to select products, making the situation with apples and garlic the exception rather than the trend.

Agricultural Trade & Export Potential

Since 2002, U.S. exports of agriculture, forestry, and fishery products to China have increased from $2.3 billion to $7.7 billion in 2006. It is forecast to approach $8 billion in 2007. The addition of Hong Kong trade—a large share of which ends up in the mainland—increases the 2006 figure to almost $9 billion. In 2008, China is projected to be the fifth largest U.S. overseas market. Given China's rising incomes and demand for raw materials and finished foodstuffs, FAS forecasts its imports will continue growing well into the future. It is expect that China's consumers will continue to absorb a rising share of the world's food and agriculture resources, and the United States is positioned to enjoy a growing market too, but not without the commitment of sustained USDA and industry programs and resources.

The current level of U.S. exports to China is comprised of about 80 percent bulk commodities and intermediate products such as soybeans, cotton, hides and skins, and wood products, whereas processed and consumer-ready products still occupy a lesser, but growing share. This past year poultry products emerged as the fourth leading U.S. agriculture product exported to China by value.

To sustain/increase China's imports of bulk commodities and to further penetrate China's booming market for higher-valued products, the United States must step-up market access and market promotion efforts. Further, the emergence of food safety as a top bilateral policy issue during 2007 demands that USDA's long-standing partnership with China's trade and government be strengthened, including enhanced technical engagement between our regulatory officials and scientists. Witnessing China's double-digit economic expansion, U.S. competitors continue to challenge the U.S. industry's efforts to market our goods, though the Made in USA label still carries an image of excellent quality, safety, and reliability in China.

China's farm and fisheries sector export focus has shifted to more labor-intensive products, such as horticultural products, livestock, and aquaculture. China is the world's largest producer and exporter of aquaculture products with profits exceeding $10 billion in 2007. China is also the world's largest importer of soybeans and cotton and also a very large importer of hides, seafood, and unprocessed wood. Imports of cotton, hides, and skins for the garment and shoe industry continue to grow, as well as imports of seafood and high-value poultry, and other meat products for re-export after processing.

With an emphasis on providing labor intensive valued added processes to food products, often imported from the United States, China processes and exports processed products around Asia. Seafood, meat, vegetable, and fruit exports to Asia account for over 50 percent of China's total exports in each category and China's exports of processed fruits and vegetables account for 60 percent of its total value of fruit and vegetable exports. With notable exceptions, including apple juice, fresh deciduous fruits, garlic, onions, and edible brassicas (mainly broccoli and cabbages), China's agricultural products do not pose a significant competitive challenge to U.S. exporters in terms of quality.

The value of China's apple juice exports to the United States increased from $1 million in the early 1990s to $108 million during the 2002-2004 period, and China has replaced the

United States as the leading exporter of apple juice to Japan and Canada (USDA, 2006). As a result of high levels of Japanese foreign direct investment in China, low production costs and proximity to Japan, some Chinese vegetables complete directly with U.S. products. The declining U.S. market share in Japan and other Asian markets for these products coincides with China's increased exports.

China's WTO Commitment on Trading and Distribution Rights

China joined the World Trade Organization in December 2001 with full membership obligations being phased in over ten years. In exchange for substantial tariff reductions and a wide range of market access concessions covering nearly every sector of the economy, China improved its access to WTO member countries, especially those less open than the United States but accession agreement implementation, especially for agriculture, is inconsistent and certain areas remain contentious.

China anticipated an immediate and positive impact on its agricultural export sector with accession to the WTO, especially for labor-intensive agricultural products such as vegetables, fruits, livestock and poultry products, and seafood. These expectations proved unrealistic and China remains critical of the United States, Japan and other trading partners because of a lack of access for its products. Sanitary and phytosanitary (SPS) standards have prevented substantial growth in these agricultural exports. According to China's Ministry of Commerce, about 90 percent of China's exporters of foodstuffs, domestic produce, and animal by-products were affected by foreign technical trade barriers, and China suffered losses totaling $9 billion in 2002.

Further, China's Ministry of Agriculture argues strongly that the WTO concessions made as part of accession are partially responsible for the farm sector's increased exposure to imported commodities, in particular, soybeans and cotton. As a result, officials state that any further agricultural liberalization including tariff cuts, relaxation of tariff rate quota (TRQ), or elimination of import licensing, is off the table.

On the import side, market access and SPS issues remain. China's food quality regulatory and supervisory system cannot yet cover the country's predominately small-scale agricultural and food production, yet stringent regulations are imposed on imports. Many regulations in China are either outdated or inconsistent with international standards and insufficient to meet the present requirements of international trade for most products. Implementation is devolved to the provincial level where significant increases in corruption are limiting the ability of provinces to effectively enforce appropriate regulations where they are in place. Thus, antiquated production techniques and technology and the lack of effective supervision to control agricultural production and processing, coupled with noncompliance with regulations has resulted in China's producers often misusing or abusing chemical fertilizers, pesticides, and antibiotics and leaving consumers exposed to pathogens, contaminants, and additives.

Separately, China also needs to liberalize its rules governing the granting of trading and distribution rights for foreign invested enterprises. An increased foreign presence in the trading and distribution sector is expected to lead to greater export opportunities for U.S. agricultural products. As part of China's WTO accession in December 2001, China agreed to open its trading and distribution sectors to foreign invested enterprises by the third anniversary of its accession. Nevertheless, substantial barriers remain. Efforts to address and rectify industry concerns about limited market access are a constant undertaking, highlighted by U.S.-China Joint Commission on Commerce and Trade (JCCT) meetings and other forums. The American Chambers of Commerce in China and the

U.S.-China Business Council also actively work to address market access and other trade issues.

Regulatory Transparency

China's SPS measures continue to pose a serious problem for U.S. agricultural producers exporting to China. Inconsistent enforcement at the ports or standards that do not meet international norms are the crux of the problem that results in trade disruptions or ongoing import bans. The United States repeatedly engages China on a number of SPS issues, bilaterally in high-level meetings such as the JCCT, and multilaterally during meetings of the WTO's SPS Committee and the transitional review held each fall.

China's commitments relating to TRQs on bulk agricultural commodities are of particular importance to U.S. farmers. These products include wheat, corn, cotton, and vegetable oils. Since China began implementing these commitments following China's accession a series of problems have undermined the market access envisioned by WTO members. Although progress has been made on some of these issues, NDRC's lack of transparency continues to create significant concern.

In the area of import requirements, China manages the flow of certain farm products through the issuance of Quarantine Import Permits (QIP) and Automatic Registration Forms (ARF). As a result, trade interruptions occur when importers are refused these documents or when China enforces time period or volume constraints. These regulatory instruments function as a de facto non-tariff barrier or tax on imported agricultural products.