UK–China Commercial Relationship

Assessing the UK–China Commercial Relationship

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As the UK formulates its post-Brexit relationship with China, one key policy interest is the possibility of stronger commercial ties. However, the benefits of doing business with China are less straightforward in light of the complex commercial and political landscape of the world's second-largest economy.

The visit of President Xi Jinping to the UK in 2015 led to the announcement of a ‘Golden Era’ of UK–China relations, promising closer bilateral cooperation and an enhanced commercial relationship. While the commercial promise of China has beckoned since the time of Marco Polo, the reality has always been less straightforward.

What is different about China is that business is not always ‘just business’

The UK consistently runs a trade deficit in goods with China. Although the UK runs a surplus in services, this is a fraction of the commercial bilateral relationship. While British companies have built successful, profitable businesses in China, market access remains a frustration for many. Since 2000, the UK has been the largest recipient of Chinese foreign direct investment (FDI) in Europe. Yet, as issues of national security and geopolitics become increasingly intertwined, there is a growing debate about how beneficial this relationship is for the UK. In addition, tensions in the US–China relationship threaten to spill over, affecting the calculus for doing business with China.

Barring a policy of complete isolationism, commercial relationships between China, the world's second-largest economy, and the UK, the world's sixth-largest, will be important. Individuals and companies will trade to mutual advantage as the economies grow. The policy question is when and where to influence the development of the commercial relationship in the UK’s broader interests. How great is the potential benefit of an enhanced relationship? And what risks and costs does the commercial relationship pose for the UK even when the commercial benefits are clear?

We start here, in the first of two articles, by considering the commercial relationship today and its potential for growth. In the second article, we will consider the risks and vulnerabilities arising from the relationship and the role they may play in the UK’s foreign policy choices.

The UK–China Commercial Relationship Today

Trade in Goods and Services

Since 1999, the UK has consistently run an overall trade deficit with China, growing to a deficit of £20 billion in 2010 and remaining broadly stable since then. In 2019, the deficit on trade in goods was £21.1 billion.

In the same year, goods exports to China amounted to £25.8 billion, 6.9% of total exports, making China the UK’s third-largest export destination, behind the US and Germany. This is up sharply from 2018, representing a 37% increase. Exports of spirits, for example, grew 35%. The main exports are crude oil, cars and pharmaceuticals with ‘unspecified goods’ as the largest category. These imports from the UK play a lesser role for China: the UK was only China’s 21st-largest import source in 2018.

In terms of UK imports, China was the second-largest source behind Germany, amounting to £46.9 billion, 9.3% of total imports. The largest product categories are telecoms equipment, office machinery, various consumer manufactured articles (for example, toys) and clothing. This reflects China’s position as the world’s largest manufacturing exporter. The UK was the ninth largest export destination for China in 2018.

The picture on services trade is significantly more positive. In 2018, the UK exported £4.6 billion in services to China, with a surplus of £3 billion. The main areas are tourism, education, financial services through the City of London and other business services. However, services trade with China is much smaller than trade in goods, and China accounted for only 1.5% of UK services exports in 2018.

UK–China Investment Flows and Operations

Data on bilateral investment is less transparent than for trade (this is because investment flows through other jurisdictions before its final destination as well as reporting inconsistencies). While the UK has historically invested
more in China than China in the UK, this has switched in recent years.

Since 2000, the UK has received £45 billion in FDI from China, more than twice the amount invested into Germany (£20.3 billion), the second-ranked European destination over this time. According to a 2020 MERICS report, the share of the Big Three (UK, Germany and France), which have traditionally received the most Chinese capital, dropped to 34% of total investment in 2019, compared to 45% in 2018 and 71% in 2017. The UK ‘remained the second largest recipient of Chinese FDI by volume in 2019’. For 2019, estimates for Chinese investment range from £3 billion to £6.5 billion. Despite the UK’s prominent position in Europe, Chinese FDI represents only around 2% of total UK investment spending annually.

Chinese companies so far have a limited presence in the UK. The largest 800 Chinese-owned companies in the UK have 71,000 employees and turnover of £91 billion. These include state-owned companies, Chinese private companies and established British companies that Chinese companies have acquired. Major financial institutions such as Bank of China and Ping An have established operations in the City, and internet companies Alibaba and Tencent are also present.

The bulk of revenues (70%) are in the industrial sector. For example, in 2008, Zhuhou CRRC Times Electric acquired Dynex, the UK’s largest high-voltage semiconductor manufacturer. Most prominently, Huawei (UK) reported revenue of £1.24 billion and 1,400 employees in 2018. And, in March 2020, Jingye Steel acquired British Steel. The consumer sector has the most Chinese companies, many being acquisitions of British brands seen to have commercial potential in China, such as Aquascutum, House of Fraser, Weetabix and Wolverhampton Wanderers. The track record for these has been mixed.

In the other direction, UK investment into China was reported at £2.9 billion in 2018, 150% higher than 2017. For the largest British companies, a divide has opened up between those for whom China is a critical part of their global strategy and those who have decided that returns in China do not justify the effort. Similarly, while some smaller companies find exciting opportunities in areas such as technology, design and education, others find regulatory and cultural differences too great.

Overall, companies have found the greatest opportunities in the consumer, pharmaceutical and automotive sectors, as well as some financial services. These include AstraZeneca, Diageo, Unilever, Intercontinental Hotels Group (IHG), HSBC, Rio Tinto and Jaguar Land Rover. All are UK-based multinationals for whom both China and the UK are integral parts of their global business and operations.

Aggregate data on the scale of these businesses and the direct impact for the UK are patchy. As examples, in 2019, AstraZeneca’s China revenue was £3.9 billion, 21% of global sales. For IHG, China accounted for 8% of profit, 15% of rooms and 30% of planned, new rooms as of October 2019. HSBC derives the bulk of its profits from China, including its operations in Hong Kong – about 80% in the third quarter of 2019. Such success in China contributes to a competitive business
globally. It typically draws on head office, manufacturing and R&D activities in the UK, creating jobs, profits and tax revenues.

In sum, China is an important part of the business for many UK-headquartered companies. Chinese companies are also increasingly present in the UK through acquisition and greenfield operations, with some such as Huawei having a prominence out of proportion to their size.

**UK–China Commercial Potential**

The potential for a larger, more rewarding relationship lies in four areas: the future growth of the Chinese economy; the opportunity for foreign companies to take a larger market share in China; the opportunity for British companies to do a better job relative to competitors; and the opportunity to benefit more from Chinese investment into the UK.

China will continue to grow, though at a slower rate, with higher growth in some sectors where the UK is strong.

China’s economy has significant structural challenges, including reducing dependency on debt-financed capital investment as a source of growth; managing export dependency in a more protectionist world (especially in relation to US–China tensions); and an ageing population. It is also dealing with the impact of coronavirus. Growth will almost certainly be slower than in the past 20 years, with China recording its slowest growth in 29 years (6.1%) in 2019 from the year before. However, growth rates will still compare favourably with developed economies. As the world’s second-largest economy, China has an increasingly wealthy population, a large, urbanised middle class and a policy focus on increasing rural incomes to alleviate poverty, reduce inequality and help boost consumer demand. Chinese demand will grow in most categories where the UK exports or operates today. Particular growth areas include technology, high-end consumer products and the services sector, especially education, healthcare and finance.

These areas fit well with what many, such as Standard Life, AstraZeneca, Burberry and Westminster School, can offer. Changing consumer demands and increasing wealth offer large opportunities for British companies to do more business in China.

However, despite some continuing liberalisation, foreign companies are unlikely to gain a greater share of the Chinese market overall.

Over the past 40 years, the reform and opening up of China’s economy has seen relative openness in certain sectors, while other sectors remain off-limits to foreigners – and, generally, also to the Chinese private sector. The consumer goods, pharmaceuticals and automotive sectors are open, albeit through mandatory joint ventures in the case of the automotive sector. Telecoms, energy, natural resources and much of the financial sector have been closed. Most Internet-based business are effectively closed to foreign ownership.

A 2019 McKinsey report examined China’s integration with the rest of the world on the eight dimensions of trade, firms, capital, people, technology, data and culture. It found that ‘China has been reducing its exposure to the world, while the world’s exposure to China has risen’.

The prospects of this changing are mixed indeed, with clear moves towards both greater openness and greater isolation.

Indeed, moves towards a closing include many government initiatives that focus on building local capability, especially in technology, including the ‘indigenous innovation’, ‘Made in China 2025’ and ‘China Standards 2035’ initiatives. These promote Chinese leadership across 10 industry sectors, including in clean energy vehicles and equipment, automated machine tools and robotics, and biopharma. The US imposition of sanctions against ZTE and then Huawei has reinforced Chinese efforts to reduce dependence on foreign technology suppliers. For example, the Chinese government has announced a switch from foreign to Chinese software and PCs in government offices.

There are also clear moves to openness in other sectors where China is liberalising restrictions on fully foreign-owned investment. In 2019, Tesla opened China’s first fully foreign-owned car factory in Shanghai; BASF officially launched its $10 billion wholly-owned plastics investment project in Guangdong; and BT was the first foreign telecoms company to receive nationwide licenses in China for Internet service and VPN provision to its multinational clients. In the financial sector, China has removed foreign ownership limits in securities, insurance, asset management, pensions and banking in the past 12 months.

The political constraints on investments in the US increase the attraction of the UK

How successful foreign companies are in China is not just a question of policy choices and implementation. As China becomes richer and Chinese companies become more competitive, the economy is naturally becoming more domestic in its focus. Exports have fallen from 36% of GDP in 2006 to 20% in 2018. Imports too fell from 28% in 2005 to 19% in 2018. Yet this share is still higher than the share of imports in the US economy – stable, at 17% of GDP from 2005 to 2018. Chinese companies are increasingly competitive and capable. They are often better able to understand local customers, respond rapidly to market changes and increasingly innovative. This limits how much foreign companies can expect to grow. Retailing provides one example. Tesco sold 80% of its China operations in 2014 and then...
sold the remaining 20% in 2020. Carrefour struggled in China, but its operations thrived once Suning acquired 80% of the operations and took control.

With the right support and focus, there is scope for British companies to do more business with China.

The fact that German exports to China are four times larger than the UK’s is often lamented and suggests more can be done. However, British businesses are unlikely to be passing up profit opportunities easily. They assess the attractiveness of China export opportunities relative to other countries and make commercial decisions. Indeed, the UK’s industrial structure is quite different from Germany’s strong engineering and chemicals manufacturing base.

The 2019 agreement to allow beef exports to China for the first time in 20 years is reported to be worth around £230 million in exports in the first five years. At the regional level, Manchester has been particularly successful at developing relations with China under the framework of the Manchester China Forum. The Manchester–Beijing direct flight connection helped stimulate exports of both goods and services in the form of Chinese tourism.

The fair wind of the ‘Golden Era’ no doubt provided a favourable context for these initiatives, but that alone was not sufficient. China signs many memorandums of understanding (MOUs) for different initiatives and projects, but many lead nowhere. Persistent follow-up is needed to have the best chance of converting MOUs into concrete actions. Top-level engagement from the British government is needed. Headlines on the UK–China commercial relationship focus mostly on Chinese investments into the UK (for example, Huawei and Jingye Steel) and—at times—the expansion of British companies in China. Exports to China can perhaps receive a greater focus. Furthermore, experience suggests that China may, at any time, link the success of these efforts to the state of the broader UK–China relationship. The complexities of political impacts on the bilateral commercial relationship will be explored in the second article of this series.

Imports and investments from China are likely to remain high in the absence of policy interventions. China continues to be both the world’s largest exporter and was the second-largest source of outbound investment globally in 2018. It remains a large investor despite an 8% investment decline in 2019.

How much British consumers and companies buy from China in the future depends on its competitiveness in terms of cost, quality and image. China is already shifting from a low-cost focus as costs rise. Subject to the usual anti-dumping and consumer quality regulation, imports will continue to be strong.

In terms of investment, China is interested in much that the UK has to offer—especially finance, education, consumer brands, healthcare and technology. Efforts to acquire British companies and intellectual property will increase of their own accord. Improved access to London’s financial markets, for example through Shanghai–London Stock Connect, is of great appeal at a time when Chinese overseas listings in the US are under threat and Hong Kong faces political uncertainty. While many countries compete aggressively for Chinese investment irrespective of, or even perhaps because of, the geopolitical environment, the political constraints on investments in the US increase the attraction of the UK. Such investment brings job creation and increased economic activity. The Manchester China Forum has documented benefits from its relationship with China—'The China Dividend’—and aims to secure more investment in future.

The policy consideration is whether investment from China has a particular value over investment from other countries—or if it has particular risks, which go beyond the commercial decision-making of individual British companies.

Chinese investors might pay a higher price or invest when others do not want to. This is superficially appealing. But, in a world of developed capital markets, funding for commercially attractive opportunities is typically available. If a Chinese investor offers the best or only deal, it begs the question of what other, non-commercial benefits are being assumed.

For Chinese investment, the role of the Chinese Communist Party in both state-owned and private companies means that business cannot be kept clearly separate from state priorities. Interest may reflect national priorities in securing access.
UK companies can continue to benefit from China’s economic growth through increased exports and operations in China. In many sectors, they are well-placed to do so despite oft-mentioned challenges. Increased, targeted government efforts can help. We should not, however, expect a dramatic change in market access or a sea-change in how the Chinese economy operates. The trade deficit on goods will remain and growth in services will not compensate.

The UK will remain an attractive destination for Chinese investment. Such investment brings jobs, stimulates demand, can support regional regeneration and improve links to China, in turn enhancing exports. In commercial terms alone, however, there is little that is unique about investment that comes from China rather than other countries.

What is different about China is that business is not always ‘just business’. The reassertion of the primary role of the Chinese Communist Party across all activities has made this clear – whether the business partner is state-owned or private. Day after day, business is indeed ‘just business’ – until suddenly it is not. There are numerous recent cases where China has used, or threatened to use, its commercial relationship with a country to influence policies it does not like. Alongside the benefits of the UK’s commercial relationship with China, we must consider how it may constrain foreign policy options. In a second article, we will explore whether the relationship is one of interdependence or dependence.

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