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Future UK Economic Relations with China: A Response to DSF Questions

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Now positioned outside the European Union, the United Kingdom's future relations with major economic powers is an issue of major importance. This paper seeks to address a series of provocative and insightful questions on the future of UK trade relations with China posed by Lady Olga Maitland.

Can the UK afford NOT to trade with China?

An interesting thought exercise is whether you would ever consider asking: "Can the UK afford NOT to trade with Switzerland?" "Can the UK afford NOT to trade with Italy?" Aggregate economic data suggests the People's Republic of China (PRC) is a partner of note for the UK in some areas, but is far from the most consequential market or source of overseas capital. Based on 2018 data (most recent available) the European Union is far and away the most important trading bloc for the UK, with bilateral trade surpassing £420 billion. Viewing things in terms of total trade with individual countries, the USA is Britain's most important trading partner, followed by Germany, the Netherlands and France (see Table 1). The PRC is number 5 on the list, accounting for half of the bilateral trade with Germany and just 1/3 of that of the USA. Like many countries, the UK runs a major trade deficit with China. In terms of UK exports, the PRC is a less important market for Britain than Ireland and roughly the same as Switzerland or Italy. The USA accounts for nearly 19% of total UK exports, but China is just 3.6%.

Table 1: Trade Balance with Top-10 Economic Partners

	2018 data	Total trade (£bn)	Exports (£bn)	Imports (£bn)	Surplus/deficit (£bn)
1	USA	201.6	123.5	78.1	45.4
2	Germany	136	56.7	79.3	-22.6
3	Netherlands	94.7	44.8	49.9	-5.1
4	France	86	41.9	44.1	-2.2
5	China	68.3	23.4	44.9	-21.5
6	Ireland	62.5	37.6	24.9	12.7
7	Spain	50.4	18.2	32.2	-14
8	Belgium	48.8	19.4	29.3	-9.9
9	Italy	46.9	21	26	-5
10	Switzerland	34.7	21.8	12.9	8.9

Source: UK Trade in Numbers (February 2020)

With respect to foreign direct investment into the United Kingdom, China does not rate as a major source of overseas capital. More than ¼ of all overseas investment comes from the United States. Western Europe and Japan round out the rest of the top-10 (Table 2).

Table 2: International investment stock in the UK by country

	2018 data	Investment (£bn)	% total
1	USA	417	27.4%
2	UK Offshore Islands	141	9.3%
3	Netherlands	138	9.0%
4	Luxembourg	111	7.3%
5	Belgium	94	6.2%
6	Japan	89	5.9%
7	Germany	84	5.5%
8	Switzerland	67	4.4%
9	France	55	3.6%
10	Spain	50	3.3%
	Rest of World	275	18.1%
	Total	**1,521**	**100%**

Source: House of Commons (December 2019)

Assessments of an economic partner's value is not about what they are doing today but what we might think they will do in the future. China has, of course, logged record economic growth over the past two decades; however, as the size of the workforce has begun to shrink, the period of extensive growth has ended. This renders China a middle-income country with considerably heterogeneity: more developed regions possess standards of living comparable to poor EU nations while less developed interior provinces lag countries like Botswana or Turkmenistan. Avoiding the middle income trap and making a move to a productivity-generated intensive growth model requires navigating the challenges of a rapidly aging population and skyrocketing debt, not to mention the crowding out effects of the country's inefficient state owned enterprises (SOEs) that generate less than 30% of GDP while devouring 80% of the country's available credit.

Even more challenging for China is innovation—which is a key engine of modern economic growth. Xi Jingping himself declared last May that the inability to innovate was the country's "Achilles heel." There is no question that China's economy is climbing the innovation ladder — which ranges from simple copying to pathbreaking innovation — however, when it comes to high-end technologies ranging from semi-conductors, to jet engines, to machine tools, the country is still highly dependent on imports of such goods from advanced economies like the USA, Germany, Japan, Taiwan and the UK. In the digital space, China is a major innovator in areas like mobile payments, gaming, messaging, and other apps involving phones. However, these things are at the low end of the innovation scale. When it comes to more complicated technologies, however, the areas that are getting China international recognition, like solar panels, fast trains, 5G, and wind turbines, are all based on foreign technologies acquired by both above-the-board and illicit means. All of this is not to say that economic reform in the PRC is impossible, but in assessing future potential as an economic partner, one would be wary to avoid straight line projections of economic growth and presumptions that past performance will be an indication of future returns.

Is one of the difficulties being the 'fear of the unknown.' An unfamiliar country, far away…?
Can we, should we do business with a society entirely different from the West?

Some have suggested that the primary challenge of dealing with China is rooted in different cultures, which might lead to the idea that better understanding alone can bridge divides. While culture certainly matters, the fundamental issues are political-economic in nature. The World Trade Organization still does not consider the PRC to be a market economy because of the level of state interference in the economy. Trade with China is not an economic interaction with a "normal" country, but with a party-state. This has two key implications for the UK. First, economic entities in the PRC, such as companies, are not truly independent actors and are beneficiaries of subsidies and other state advantages, such as forced joint ventures with foreign firms for the purposes of technology transfer. Moreover, preferential access to the country's more than 1 billion consumers is a huge boon for large Chinese private and state-owned enterprises. European firms attempting to do business in China do not have the same access and freedom of operation that Chinese firms doing business in Europe or the US do. The challenge is not that the society is "entirely different from the West," but rather that they are attempting to operate under economic "rules of the game" that are different and considered to be "unfair" in the west.

The second major challenge of dealing with a party-state is the weaponization of their economy as a tool of political influence. Highlighting the economic benefits of cooperation and the costs of disobedience are a key means for the Chinese Communist Party (CCP) to gain compliance and encourage both countries and companies to self-censor opinions and behaviors that Chinese leaders find objectionable. China is hardly alone in the use of economic statecraft, not is it the case that European countries never use economic sanctions. Unlike European sanctions, however, which are publicly announced and are implemented in accordance with open legal regimes, China's economic coercion is rarely made explicit and is often concealed in selectively enforced legal and technical regulations for plausible deniability. When European countries use targeted sanctions, they are specifically designed to affect political elites who are involved in a particular malign policy. With Chinese coercion, however, companies' economic fortunes are targeted based on their nationality—irrespective of their links to whatever issue the Chinese government is objecting to—specifically to try to compel corporate leaders to push back against their own government's policies. Among the better-known examples of these policies:

- After the 2010 Nobel Peace Prize was awarded to Chinese dissident Liu Xiaobo, administrative regulations blocked Norwegian salmon imports to China for six years until the Norwegian government apologized and "admitted" that its actions had harmed "mutual trust."

- In 2012, when the Philippines objected to Chinese claims on some of their islands in the South China Sea, Philippine banana exports to China suddenly failed to meet "sanitary" standards for a four year period that came to an end with the election of a new, more friendly, government in Manila.

- The decision by the South Korean government to deploy a US-made missile defense system in 2016 to defend against North Korea earned Beijing's ire. Chinese tourism to South Korea was curbed, Korean cosmetics exports and pop-music imports were cut, and ninety grocery stores in China owned by a South Korean company were all forcibly closed due to "fire safety" concerns. The boycott came to an end after Seoul promised no additional deployments of US-made missile defense systems, no participation in any US regional missile defense system, and no trilateral alliance with the US and Japan—all of which represent a significant infringement on South Korea's sovereignty. Total costs to the South Korean economy are unknown, but lower bound estimates are in the range of £15 billion, with other sources reporting much higher figures.

- This past week, Australia's push for an independent investigation into the origins of the COVID-19 virus was met with the sudden imposition of an 80% tariff on Australian barley exports—after the Chinese ambassador threatened similar punitive measures on Australian exports of beef and wine.

Pressure is not just applied to countries—in some cases, individual companies are targeted. In May 2018, British Airways removed references implying Taiwan was a separate country from its website after being threatened by the China's Civil Aviation Administration. In October 2019 it was the National Basketball Association (NBA) in the United States that came under fire after the manager of one of their teams sent a tweet on his personal account expressing solidarity with the Hong Kong protestors. Although Basketball is China's most popular support—with more than 600 million people watching NBA games annually—both the state broadcaster and the league's online streaming partner announced they would no longer show NBA games. Including the Chinese business partners who cut ties following the incident, the NBA is expected to lose upwards of $400 million in revenue. The NBA initially criticized the manager's remarks, which engendered a domestic backlash in the USA where freedom of speech a cornerstone of American political identity and led the league to reverse course by announcing that they refused to censor players or teams. The episode has not been fully resolved, but it highlights the ethical risk engendered by significant financial exposure to the Chinese market in the face of a government that is willing to use its financial clout to punish those who do not toe the party's line.

The examples cited above should be sobering, but not disheartening and they should lead to caution, but not the conclusion that the UK is a completely helpless actor. Economic interdependence can be strategically employed to further British interests as well. For example, if the USA follows through on plans to delist Chinese companies from its stock exchanges, Chinese businesses will be even more desperate to gain access to the City and the ability to be able to be listed on British financial markets. <u>Such important levers of influence need to be recognized and used to the country's advantage, not simply given away for "free."</u> The problem is that in an open democratic system, various political and economic elements are not typically well coordinated or even used to thinking in such terms. Auditing the country's strategic economic assets and thinking through ways to leverage them as tools of influence in dealing with Beijing is a necessary exercise. Instead of asking if the UK can demonstrate its independence by trading with China, the focus should be on how the UK intends to keep its independence while trading with China.

Is it realistic to break the production chain, and if so why?

Supply chain diversification—in particular reducing reliance on China-based producers—is a hot topic among foreign policy analysts. The viability of such an undertaking will depend on the industry and sector one is talking about. However, we should recognize that private firms have been shifting some of their production from China for years, as rising local costs and increased sophistication of neighbouring economies combined make other countries more competitive. These effects were further magnified by the US-China trade war as firms sought to spread their risk and exposure. Similarly, even before the COVID crisis, national security analysts in the United States, Australia and elsewhere were highlighting the need for resilient and diversified supply chains. The pandemic has thrown the failure to do so into stark relief. Japan has taken the firmest measures to date, establishing a £1.85 billion fund to help firms relocate their production to Southeast Asia or back to Japan. The U.S. and Australia are also taking measures to reduce supply chain vulnerabilities, which is being encouraged by officials and business leaders in France and Germany as well. Autarky is not the answer for the UK, nor is a total risk reduction likely to be economically feasible. However, a mutually beneficial and coordinated diversification strategy with key allies and trusted suppliers could be a smart way forward for "Global Britain."

Are the templates of economic power shifting away from the U.S.A?

As the Nobel-prize winning physicist Niels Bohr allegedly quipped, "prediction is very difficult, especially if it's about the future." This admonishment aside, it would appear significantly premature to conclude that the templates of economic power are shifting away from the USA. Scholars of international political economy contend that US economic advantages are structural and long-term. Despite media hype, it is hard to find signs that US dominance of the global monetary order is diminishing. It has been a fact of life for decades that the dollar is involved in 80% of foreign exchange transactions and that more than 60% of global currency reserves are dollar dominated (versus 20% for the Euro and 5% for the Yen).

The centrality of the US dollar grants the United States government a host of advantages including enhanced borrowing and buying power. Similarly, individuals and corporations can increase their international acquisitions in holdings without generating domestic fiscal disputes. The inter-relationship between the U.S. Federal Reserve and American banks provides American companies easy access to credit that they can use to generate additional profit, win market share worldwide and boost employment. Speaking in 2009, in the wake of the global financial crisis, China's chief bank regulator, Luo Ping, famously said China found itself hostage to US privileges: "Except for US Treasuries, what can you hold? Gold? You don't hold Japanese government bonds or UK bonds . . . We know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do."

The situation has only been enhanced by the current coronavirus crisis where we see governments, businesses, and private investors flooding into dollars. Lest one think that this is a transitory phenomenon, one of the key elements underwriting dollar dominance is the centrality of American financial institutions in the history of the international economic system. This phenomenon is self-reinforcing: since US investment firms and banks have been at the core of the system historically, network feedback sustains their importance today and into the future even if they are arguably no longer the most competitive actors in their sector.

When it comes to future economic growth, and in particular innovation, the US possesses a number of advantages. American universities are world-leading and foster a culture of both innovation and commercialization of new technologies. When it comes to both basic and applied R&D, the US is a global leader in both public and private investment. The US financial system is geared to support innovation and efficiently allocate capital across business types. Legal and regulatory structures facilitate the development of marketable products while rewarding innovation with proper intellectual property protection. Thus, the US possesses an innovation ecosystem that is hard to replicate elsewhere.

There is no question that the extensive COVID stimulus measures undertaken by the Trump administration to stave off economic crisis will increase future debt and deficit levels. This in turn will likely lead to pressure to reduce federal spending in future years and also make it harder to make investments in education, infrastructure, and research and development. Without overlooking these issues, it would be a mistake to underestimate the long-term, structural advantages undergirding the US role in the world economy.

Should the West be the arbiters of political institutions in other countries?

The global pandemic has clearly illustrated the fact that in an interconnected world, who governs a given country and how well they do it can literally be a matter of life and death in the UK. When it comes to trade relations, however, it is not about serving as the arbiter of political institutions in another country, but clearly understanding the political impulses that drive actors in a given system and the effects that those dynamics can have for your economic intercourse. Armed with knowledge of the political institutions that govern a given country, it is possible to decide whether you want to do business with them.

Conclusion

Global Britain can prosper in an environment where open markets and transparent legal systems allow the country to trade with anyone who follows the same set of rules. The UK will be far poorer if acquiescence to the political whims of a major power is the key criteria for beneficial economic engagement. If the Chinese market remains important to British exporters and the conditions are right, more significant economic integration with China may make long-term sense, however, such an objective should only be adopted after a careful weighing of the opportunity costs and an identification of ways to mitigate the risks.

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