China and the UK

Changing patterns of international trade and investment

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Summary

China's economic growth over the last two decades has been truly remarkable. Averaging near double-digit percentage growth each year, it is now the second largest economy in the world based on gross domestic product (GDP) and is expected, one day, to overtake the USA and become the largest. China's growth has been predominantly export driven and centred in manufacturing, especially since joining the World Trade Organisation (WTO) in 2001. This article looks at how the rise of China has impacted on the UK's international trade and investment and also how the continuing development of China may affect these in the future.

Introduction

The current account part of the Balance of Payments reflects one nation's transactions with the rest of the world in goods trade, services trade, income flows and current transfers. Since 1992 the UK has run a deficit on its current account averaging around 2 per cent of GDP (**Figure 1**). However, during this period, the UK's current account deficit has varied from 0.1 per cent of GDP in 1997 to 3.4 per cent in 2006. The share of the deficit accounted for by international transactions with China has steadily increased. In 1992 the UK's deficit with China was 0.1 per cent of GDP. By 2009 the deficit had grown to 1.2 per cent, with the size the deficit increasing faster after 1999. Given that the overall UK current account deficit in 2009 was 1.1 per cent of GDP – it shows that once China is excluded the UK's current account position with the rest of the world would actually be in surplus.

The UK's growing current account deficit with China is the result of faster growth in debits (imports and income outflows) than credits (exports and income inflows). Debits with China, as a percentage of all debits, increased from 0.5 per cent in 1992 to 4.3 per cent in 2009, whilst the

corresponding share of total credits accounted for by China increased from 0.3 per cent to 1.5 per cent.

These are interesting figures showing that, despite China's growing importance in the global economy and the UK's Balance of Payments, it still represents a fairly small part of the UK's total trade and income transactions with the rest of the world. Most of the transactions recorded in the UK's Balance of Payments are still with advanced mature economies, particularly within Europe and the USA.

China's main impact on the UK's current account is in the trade in goods balance – particularly as a source of goods imports into the UK. On the other hand, China–UK trade in services and income flows related to the international ownership of financial assets – which are both an important part of the UK's current account due to the high degree of services specialisation in UK output and the role of the City of London as a major international financial sector – are still very small.

The aim of this article is to look at the extent and nature of UK–China trade and investment in more detail, not only recent trends but also how these might change as China continues its remarkable and fast-paced development.

Figure 1 China and the UK current account

Per cent

Source: ONS Pink Book

Trade in goods

The UK's deficit with China in the trade in goods has increased from a negligible amount in 1992 to 1.4 per cent of GDP in 2009 (**Figure 2**). The UK now only imports more goods from Germany and the USA than it does from China (**Table 1**). In fact, other than the USA, China is the only non-European country in the top 10 countries by imports (with Hong Kong and Japan just outside the top 10). In 1992 Chinese goods represented about 0.2 per cent of all UK goods imports, by 2009 this share had risen to 7.9 per cent (just below the USA which accounts for 8.0 per cent, see **Figure 3a**).

Figure 2 UK trade in goods balances, 1992–2009

Per cent GDP

Source: ONS Pink Book

East Asia 9 – Hong Kong, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand

China has also been a growing market for goods exports but it is still a relatively small one, with most of the UK's goods exports heading to the USA and Europe (**Figure 3b**). China is in the UK's top 10 of countries by goods exports, but accounts for just 2.2 per cent of the total.

It should be noted though, that despite China's growing prominence in goods trade, the UK's goods trade is still predominantly with Europe where the trade in goods deficit was 4.0 per cent of GDP in 2009. Specifically, the group of EU 8 countries, despite seeing their shares of total goods

imports and exports fall as a result of the rise in China and Eastern Europe – still accounted for 42.5 per cent of goods imports and 45.7 per cent of goods exports.

Table 1 **Trade in goods: country rankings**

Imports							Exports						
	2009	2008	2007	2006	2005	2004		2009	2008	2007	2006	2005	2004
Germany	1	1	1	1	1	1	USA	1	1	1	1	1	1
USA	2	2	2	3	3	2	Germany	2	2	2	3	2	2
China	3	5	5	6	6	7	Netherlands	3	3	5	5	5	5
Netherlands	4	3	3	4	4	4	France	4	5	3	2	3	3
France	5	4	4	2	2	3	Ireland	5	4	4	4	4	4
Norway	6	6	7	7	8	10	Belgium	6	6	6	6	6	6
Belgium	7	7	6	5	5	5	Spain	7	7	7	7	7	7
Ireland	8	9	9	10	10	8	Italy	8	8	8	8	8	8
Italy	9	8	8	9	7	6	China	9	10	11	15	15	16
Spain	10	10	10	8	9	9	Sweden	10	9	9	9	11	9
Hong Kong	11	12	12	12	12	12	Switzerland	11	11	12	10	10	12
Japan	12	11	11	11	11	11	Hong Kong	12	16	16	16	14	14
Sweden	13	14	14	14	13	13	United Arab Emirates	13	15	17	13	9	13
Switzerland	14	16	16	17	18	16	Japan	14	14	10	11	12	10
Poland	15	20	20	18	25	29	Canada	15	17	13	12	13	11
Russia	16	13	15	15	14	15	Singapore	16	21	20	22	21	22
Turkey	17	17	17	19	20	20	Australia	17	18	19	19	17	15
India	18	19	19	23	22	25	India	18	13	14	18	16	17
Canada	19	15	13	16	16	14	Norway	19	20	18	24	19	19
Denmark	20	22	21	13	15	18	Poland	20	19	21	17	26	28

Source: ONS Pink Book

China's surge in goods exports took off in 1992 with the 'open door' as China's exports grew at 17 per cent per annum on average during that decade. Since 2001 when it acceded to the World Trade Organisation, China quickly became the world's largest exporter accounting for nearly 10 per cent of global exports by 2009, overtaking Germany, the US and Japan.

The sector in which Chinese exports are most notable are consistent with its comparative advantage in labour-intensive products, such as clothing and textiles (**Table 2**). In fact, it was held back by the Multi-Fibre Agreement that had imposed a global quota system on exports of clothing and textiles. When it ended in January 2005, it freed up Chinese exports to such an extent that safeguards were imposed by the Europeans and Americans.

Figure 3a Changing origin of goods imports*, 1992–2009

Percentage points

Source: ONS Pink Book

Figure 3b Changing origin of goods exports*, 1992–2009

Percentage points

Source: ONS Pink Book

* Change in percentage shares. Figures in brackets are shares in 2009.

Other East Asia are the East Asian 9 – Hong Kong, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand

EU 8 – Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands and Spain

Table 2 **Goods imports from China by SITC classification**

Standard Industrial Trade Classification (SITC)	Value in 2010 (£ millions)	Share of UK total in 2010 (%)	Share of UK total in 1999 (%)	Change in shares 1999- 2010 (%)
84: Articles of apparel and clothing accessories	3,818	25.5	5.9	19.7
89: Miscellaneous manufactured articles	3,593	18.4	6.3	12.2
75: Office machines and ADP machines	3,218	23.8	1.6	22.2
76: Telecoms and sound recording and reproducing apparatus	2,815	16.1	1.9	14.2
77: Elementary machinery, apparatus and appliances	2,318	14.5	2.5	11.9
894: Baby carriages, toys, games and sporting goods	1,945	46.2	19.4	26.8
82: Furniture and parts, bedding, mattresses etc	1,612	33.6	5.7	27.9
69: Manufactures of metal	1,377	19.6	4.8	14.8
85: Footwear	1,128	31.0	5.7	25.3
74: General industrial machinery and equipment	889	8.3	0.9	7.3
65: Textile, yarn, fabrics, made up articles etc	773	17.6	2.8	14.8
893: Articles of plastics	584	16.9	6.8	10.1
66: Non-metallic mineral manufactures	565	6.9	0.9	6.0
83: Travel goods, handbags and similar containers	564	38.5	23.0	15.4
81: Prefab buildings, sanitation, plumbing, heating and lighting	496	25.7	8.8	16.9
68: Non-ferrous metals	357	4.0	1.2	2.8
62: Rubber manufacturers	348	12.5	0.9	11.5
899: Miscellaneous nes	341	18.5	12.0	6.5
78: Road vehicles	335	1.0	0.1	0.9
63: Cork and wood manufactures (excluding furniture)	328	19.2	2.9	16.3
64: Paper and paperboard	311	5.2	0.6	4.6
911: Postal packages	309	35.6	1.4	34.2
51: Organic chemicals	291	3.0	1.2	1.8
71: Power generating machinery and equipment	287	2.1	1.9	0.1
87: Professional, scientific and controlling instruments	265	3.9	0.7	3.2
Total	28,228	7.9	1.8	6.1

Source: HMRC

But, that is not the only area of China's comparative advantage. What has been impressive about the range of goods that China exports is its breadth. Across low-technology goods like toys to higher technology items like semi-conductor chips, there has been a significant upgrading in Chinese exports (the technology composition of Chinese exports is generally consistent with that of a country with three times its average income). But, because foreign-invested enterprises have produced more than half of Chinese exports since the mid-1990s and the share is higher in the

more advanced output of high tech goods, there are questions as to whether or not it represents shifting comparative advantage or the centrality of China as a global manufacturing hub.

The high concentration of foreign firms in Chinese exports is the result of long-standing policy that aimed to attract and learn from foreign direct investment to help develop Chinese industry. This policy began at the very start of reforms in December 1978 and centred on developing Chinese–foreign joint ventures through the 1980s which accelerated in the 1990s with the 'take off' of the open door policy. Then, with anticipated opening after WTO accession, wholly foreign-owned enterprises rather than joint ventures gained greater prominence. But, through the past three decades, the intent to attract and imitate the more advanced know-how of multinational corporations has been evident. In some industries, this has resulted in Chinese firms becoming competitive and stealing market share even from foreign firms such as in mobile handsets. But, in other respects, China's industrial upgrading still has some way to go.

Nevertheless, with rising wage pressures (real urban wages have risen by 10 percent on average during the 2000s) and growing competition from southeast Asian nations such as Vietnam, China had begun to move out of low-end manufactures. China seeks to move up the value chain and had since the mid 1990s, developed High-Technology Development Zones which are akin to science parks, as well as increased spending on technology and innovation. For instance, R&D spending as a part of GDP in China now ranks among the highest even among OECD countries. Therefore, part of the impressive growth across the technical expertise of Chinese exports is also due to a focus on higher value-added production as sustained economic growth will increasingly depend on more total factor productivity (TFP) growth.

Therefore, cheaper nations in southeast Asia may well benefit from the 'flying geese' pattern of trade, first observed when cheap manufactures moved out of Japan to South Korea, Taiwan and then to China and now to southeast Asia. But, for China, becoming competitive to be placed within the regional production chains for electronics trade is more desirable and suits its policies that have attempted to shape its dynamic comparative advantage.

Imports to China have also grown significantly over the last two decades but not so much from the UK (**Table 3**). The main export markets provided by China are high-end capital goods such as those sold by Germany and also by France. For instance, Germany is China's 6th largest import partner while the UK does not rank in the top 10. Consumer goods still comprise less than 3 percent of all Chinese imports. This is because of decades of protectionism of domestic markets against foreign competition to develop its own firms and industries. The barriers were originally tariff-based, for instance, there had been 100 per cent tariffs on imports. And the only foreign firms allowed to invest in China were restricted to Special Economic Zones where they could produce for export but not to sell their wares in China. After WTO accession, tariffs have fallen dramatically across the board, but non-tariff barriers remain. For instance, permission and licenses can be hard to obtain to access China's markets. And thus, lack of 'market access' is one of the perennial complaints of Western businesses.

The pattern of imports in China is likely to shift more towards consumer goods, only because there is in general greater opening after WTO accession particularly of the services sector despite the government's protective policies because services was the sector where China agreed to open under its WTO obligations. And, China is keen to develop its services sector. At 40 per cent of

GDP, it is too low by comparative standards and has plateaued in the past decade despite the government's efforts. As services is partly non-tradable, it also suits the 're-balancing' aims of the Chinese government as it tries to reduce its reliance on exports and increases the contribution of domestic demand to economic growth.

Table 3 Goods exports from China by SITC classification

Standard Industrial Trade Classification (SITC)	Value in 2010 (£ millions)	Share of UK total in 2010 (%)	Share of UK total in 1999 (%)	Change in shares 1999- 2010 (%)
78: Road vehicles	1,645	7.0	0.1	6.9
28: Metalliferous ores and metal scrap	751	18.5	1.5	17.0
71: Power generating machinery and equipment	624	3.7	0.9	2.8
74: General industrial machinery and equipment	448	4.5	1.8	2.8
54: Medical and pharmaceutical products	424	1.9	0.2	1.7
77: Elementary machinery, apparatus and appliances	348	3.2	0.8	2.4
25: Pulp and waste paper	296	54.6	4.4	50.2
87: Professional, scientific and controlling instruments	288	3.9	0.9	3.0
72: Machinery specialised for particular industries	265	3.9	1.9	2.0
68: Non-ferrous metals	249	4.3	0.5	3.7
89: Other transport equipment	199	1.3	0.2	1.0
79: Other transport equipment	145	1.4	0.5	0.9
57: Plastics in primary forms	130	4.2	0.6	3.6
76: Telecoms and sound recording and reproducing apparatus	127	1.8	2.2	-0.4
73: Metalworking machinery	106	11.9	2.5	9.4
69: Manufactures of metal nes	100	2.2	0.6	1.7
59: Chemical materials and products nes	97	2.1	0.5	1.6
67: Iron and steel	80	1.6	0.7	0.9
33: Petroleum, petroleum products and related materials	80	0.3	1.4	-1.2
75: Office machines and ADP machines	76	1.3	0.2	1.1
21: Hides, skins and furskins	75	46.1	5.0	41.1
51: Organic chemicals	66	0.7	0.5	0.2
52: Inorganic chemicals	62	1.8	1.1	0.7
88: Photographic and optical goods	61	3.5	1.3	2.2
11: Beverages	61	1.1	0.0	1.0
Total	7,225	2.8	0.7	2.0

Source: HMRC

As the Chinese middle class continues to develop consumer goods producers, especially those at the higher quality end, will find that there is a great deal of repressed consumption. The wholesale

and retail sector were only liberalised in the late 1980s and early 1990s out of the control of the state-owned enterprises. In fact, food vouchers were only abolished in 1992. Of course, China will continue to import high-tech capital goods since it cannot produce these at the moment and will want to learn from the best technology in the West and Japan. Germany, France and Japan have all grown well from exporting to China and this pattern is likely to continue as China undergoes its second industrialisation. Its 12th Five Year Plan (2011–2015) includes ambitious infrastructure building to support its urbanisation policy and also China aims to re-orient its capital more efficiently to reform its industries away from obsolete heavy industries and into higher tech sectors. So, unlike the first industrialisation which took place during the command period, China's industry which is still 50 per cent of GDP as it was in 1979 on the eve of reform, will become re-oriented. And urbanisation plus services sector development will require road, rail as well as 'soft infrastructure' to deliver government services across large urbanised areas. All of this will justify continuing capital accumulation growth and continue China's need to import capital goods as well as energy and commodities.

Trade in services

Services trade is very important to the UK current account. It reflects the UK's comparative advantage and goes some way to offsetting its perennial deficit in the trade in goods. Services trade with China has increased in the last two decades but remains a small proportion of the total. The UK's surplus with China in services trade amounts to just 0.1 per cent of GDP (**Figure 4**), tiny when compared to the services trade surpluses with Europe (1.2 per cent of GDP), USA (1.0 per cent) and even the rest of East Asia (0.4 per cent).

Although services imports from China have increased as a proportion of the total since 1992, they still only represent around 1.0 per cent of the total in 2009 (**Figure 5a**) and China is not in the top 20 list of countries by services imports (**Table 4**). China's place in UK exports of services is slightly bigger, but not by much. Although China is in the top 20 list here, China took only 1.5 per cent of all the UK's services exports (**Figure 5b**).

Even though China is, in terms of GDP, the second largest economy in the world, low services trade largely reflects its relatively low development (low consumption), high degree of state planning (limited business services) and relatively closed and restricted financial markets. For instance, in 2009 the UK exported £43.9 billion in financial services, of which just £203 million (0.5 per cent) went to China (**Table 5**). Likewise, business services exports by the UK in 2009 were £42.2 billion, of which £386 million (0.9%) went to China. The UK's largest source of services exports with China in 2009 were in transport (£940 million, 4.5 per cent of the total) and travel (£589 million, 3.1 per cent of the total). Travel is one part of the services industries where some restrictions have been lifted with Chinese nationals being now able to visit foreign countries more freely.

Figure 4 UK trade in services balances, 1992 – 2009

Per cent of GDP

Source: ONS Pink Book

East Asia 9 – Hong Kong, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand

The Chinese service sector is likely to grow quickly in the next decade which may provide export market opportunities for UK firms. Not only because of the WTO obligations but because China wants to develop such services and is using a similar approach to its way of developing manufacturing during the 1980s and 1990s. By attracting British banks and financial companies to become minority equity investors (for example HSBC and Bank of Communications, China's 5th largest bank – a state-owned bank just under the top tier of the big four is a good example as HSBC can only hold up to 20 per cent and the ceiling for foreign shareholding is 25 per cent), it is similar to the joint venture policy for industry. By working alongside foreign firms, Chinese managers and workers can learn best practise and know-how. This model pertains to all services.

The services sector has strong potential to grow because it is starting from a low base. Under the planned economy, there was no need for services as the government provided all of them. Starting in the mid-1980s, the PBOC became a central bank and the state-owned commercial banks were created. In the early 1990s, the two stock exchanges (Shanghai and Shenzhen) were created and financial services grew slowly as it was marred by scandal due to ineffective regulation. But, since WTO accession in 2001, private firms can now list on the stock exchanges and the pace of services development is rapid.

Figure 5a Changing origin of services imports*, 1992–2009

Percentage points

Source: ONS Pink Book

Figure 5b Changing origin of services exports*, 1992–2009

Percentage points

Source: ONS Pink Book

* Change in percentage shares. Figures in brackets are shares in 2009.

Other East Asia are the East Asian 9 – Hong Kong, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand

EU 8 – Belgium, France, Germany, Ireland, Italy, Luxembourg, Netherlands and Spain

Table 4 Trade in services: country rankings

Imports							Exports						
	2009	2008	2007	2006	2005	2004		2009	2008	2007	2006	2005	2004
USA	1	1	1	1	1	1	USA	1	1	1	1	1	1
Spain	2	2	2	2	2	2	Germany	2	2	2	2	2	2
France	3	3	3	3	3	3	Netherlands	3	3	3	3	3	3
Germany	4	4	4	4	4	4	France	4	4	4	4	5	4
Italy	5	5	5	5	5	5	Ireland	5	5	5	5	4	5
Netherlands	6	7	7	6	6	6	Switzerland	6	6	6	6	6	6
Ireland	7	6	6	7	7	7	Spain	7	7	7	7	8	9
Japan	8	8	8	8	9	11	Italy	8	9	8	9	9	8
Switzerland	9	9	9	9	8	9	Japan	9	8	9	8	7	7
Belgium	10	10	10	10	12	10	Australia	10	11	11	11	10	11
Australia	11	13	12	12	11	13	Singapore	11	13	10	10	12	12
Greece	12	12	11	11	10	8	Belgium	12	12	12	13	11	10
India	13	11	13	13	14	15	Denmark	13	19	17	15	18	17
Sweden	14	18	18	15	15	14	The Channel Islands	14	10	13	14	14	16
Portugal	15	14	14	14	13	12	Canada	15	14	15	16	17	13
Singapore	16	20	29	26	27	28	Sweden	16	18	19	17	16	15
Bermuda	17	17	16	17	43	-	China	17	17	23	21	20	19
United Arab Emirates	18	22	23	27	26	31	Norway	18	15	16	18	15	18
Russia	19	26	28	30	32	30	Luxembourg	19	23	24	26	28	28
Turkey	20	16	21	20	18	19	Saudi Arabia	20	16	14	12	13	34
China	25	19	26	29	24	29							

Source: ONS Pink Book

Because of the middle class achieving lower middle income level for the first time in the early 2000s, there is now a need for services. For instance, the lack of financial services and the existence of financial repression (legal/policy measures to distort credit decisions) mean that the high savings of Chinese households (22 per cent of GDP) are inefficiently allocated. The same applies to firms which have a savings rate that is now equal to households for the first time. The need for financial intermediation is apparent and the government is loosening its policies rapidly to develop the sector, albeit on an experimental basis. However, the access for foreign firms is likely to be difficult since like manufacturing before it, the Chinese government is wary of allowing large firms to dominate an under-developed sector. But, with China's greater global integration, it is more difficult to restrict access and its own firms will play an active role in wanting greater opening to partner with and transact with foreign players.

Shanghai may well rise to eventually become a competitor to London. But, as with the rise of Hong Kong or Frankfurt, there is scope for a number of financial centres and once established, spatial

agglomeration studies suggest that it is difficult to dislodge an existing hub of specialisation whether it is the City of London, Hollywood or Silicon Valley.

Table 5 Composition of China–UK trade in services

	Exports						Imports					
	2009			2008			2009			2008		
	China	Grand total	China %	China	Grand total	China %	China	Grand total	China %	China	Grand total	China %
Transportation	940	20,708	4.5	1,012	20,884	4.8	331	19,175	1.7	318	17,707	1.8
Travel	589	19,282	3.1	516	19,598	2.6	306	37,256	0.8	248	32,297	0.8
Communications	40	4,485	0.9	28	4,262	0.7	45	4,346	1.0	41	4,041	1.0
Construction	6	1,625	0.4	..	1,246	..	23	1,095	2.1	8	1,433	0.6
Insurance	25	8,333	0.3	24	7,604	0.3	62	1,108	5.6	65	1,006	6.5
Financial	203	43,852	0.5	387	52,821	0.7	205	13,146	1.6	34	10,933	0.3
Computer and information	20	6,902	0.3	21	7,258	0.3	12	3,391	0.4	14	3,818	0.4
Royalties and license fees	38	7,610	0.5	56	7,987	0.7	5	5,750	0.1	2	5,814	0.0
Other business services	386	42,243	0.9	367	44,727	0.8	343	25,218	1.4	318	27,750	1.1
Personal, cultural and recreational	56	1,951	2.9	..	2,274	..	..	1,094	..	2	667	0.3
Government	12	2,120	0.6	14	2,158	0.6	..	3,884	..	10	3,793	0.3
Total services	2,315	159,111	1.5	2,454	170,819	1.4	1,342	115,463	1.2	1,060	109,259	1.0

Source: ONS Pink Book

International income and investment

Income flows (and current transfers) are an important part of the UK current account. For instance, in recent years, the UK's surplus on its income balance has sometimes been as important as its surplus in services trade.

Income flows represent earnings and payments relating to the international ownership of financial assets. As the UK has historically been a large (relative to GDP) investor and receiver of international investment the investment income balance has always been meaningful in the Balance of Payments. The City of London's position as a major financial centre is central to this.

Figure 6a shows that the UK's income balance with China has been increasing as a percentage of GDP – but is still fairly small. Income credits and payments have generally been trending upwards (except in 2008 and 2009 when the financial crisis and recession reduced Chinese earnings from UK assets) but are still a low proportion of GDP. **Figure 6b** looks to put the significance of China–UK income flows in a more international context. From a regional perspective, China's share of East Asia credits has been rising, debits have also risen but not as quickly. However, this may in part reflect the aftermath of the Asian financial crisis. China, with its relatively closed financial markets was largely insulated from the crisis. It is still apparent from Figure 6b, that compared to the rest of the world, Chinese income flows with the UK are relatively small and not really growing that fast.

Figure 6a China–UK income balance

Per cent of GDP

Source: ONS Pink Book

Figure 6b China–UK income flows relative to East Asia and total

Percentage share

Source: ONS Pink Book

East Asia 10: China, Hong Kong, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand

Income flows are connected with the ownership of assets. As an open economy with a large financial sector the UK has a large stock of overseas assets (7.6 times GDP in 2008) and liabilities (7.7 times GDP in 2008). Much of this reflects the City of London's role as an international financial intermediary – for example borrowing £100million from wholesale markets in Asia to lend commercially in Europe and so means the UK ends up with large stocks of assets and liabilities that do not differ that much in size. In comparison, China is a tiny part of the UK's International Investment Position (IIP or net asset position). UK assets in China in 2008 were about (2.1 per cent of UK GDP) and UK liabilities to China were (1.1 per cent of UK GDP).

The UK's IIP with China has increased, both as a proportion of GDP (**Figure 7a**) and relative to the rest of East Asia (**Figure 7b**). However, its incidence is still small, especially compared to the UK's total assets and liabilities with the rest of the world. As **Table 6** shows, most of the UK's international investment is with other advanced economies.

China's low share of assets and liabilities in the IIP is not surprising when considering that most of these assets are portfolio (equities and interest-bearing financial assets) and that China's financial markets are both underdeveloped and closed to international investors. It might be expected that given China's strong position in manufacturing trade and its attraction of foreign firms to joint ventures in Special Economic Zones that direct investments may be more significant. However, as **Figures 8a** and **8b** show, FDI from the UK to China and from China to the UK are still both fairly small compared to the UK's FDI flows with other countries and regions. This may partly reflect the UK's shrinking manufacturing sector, but is mainly due to the fact that FDI positions are generally built up over many years. China is a relative newcomer to the global economy (WTO membership in 2001) and despite this it also maintains a large number of restrictions limiting investment in and out of the country.

China still officially has a closed financial account, though there are some moves to liberalise, mainly around Chinese firms and households moving some of their money to Hong Kong. The stock market is still closed as well. Only select foreign investors can invest, those known as Qualified Foreign Institutional Investors as of 2002, can invest in the 'A' share market which hold the main RMB-denominated stocks. The reasons are because of worries over the fragility of the banks, which have suffered from non-performing loans but are awash with cash because of the trapped savings in China. For instance, the current gap between the deposit and the lending rate in China (300 basis points) is simply to preserve bank margins.

Also, the Chinese are worried about liberalisation effects on the exchange rate. But, because of liquidity pressures (M2 money supply growth has been near 20 per cent in the past year) and the pressure from mature Chinese firms to operate globally, there are numerous policies that are gradually opening the financial account. Domestically, the stock exchanges are also undergoing reforms, including making all of the shares tradable (for most of the reform period, only third of the shares were tradable since all listed firms were state-owned enterprises and the majority of the shares were held by the state and legal persons which were other state-owned enterprises). For instance, exchange traded funds are being developed and greater foreign participation is being encouraged in the financial sector as the Chinese in particular are keen to develop its under-developed capital markets.

Figure 7a China–UK IIP

Per cent of GDP

Source: ONS Pink Book

Figure 7b China assets and liabilities relative to East Asia and total

Percentage share

Source: ONS Pink Book

East Asia 10: China, Hong Kong, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand

Table 6 **UK IIP assets and liabilities, 2009**

Percentage of GDP

UK GDP in 2009 = £1.39 trillion

Assets		Liabilities	
Total	759.6	Total	766.6
EU 27	340.9	EU 27	331.7
USA	219.0	USA	210.4
Germany	74.2	Germany	83.8
France	68.3	France	63.8
East Asia 10	50.8	East Asia 10	62.8
Netherlands	45.4	Netherlands	50.7
Ireland	38.6	Ireland	38.4
EFTA	33.3	EFTA	38.3
Japan	27.5	Japan	33.2
Spain	24.6	Hong Kong	13.2
Italy	17.1	Singapore	11.7
Singapore	8.2	Spain	11.5
Hong Kong	7.0	Italy	9.9
South Korea	3.2	South Korea	1.8
India	3.2	India	1.4
China	2.1	China	1.1
Taiwan	1.1	Taiwan	0.8
Malaysia	0.6	Thailand	0.4
Thailand	0.4	Malaysia	0.4
Indonesia	0.3	Philippines	0.2
Philippines	0.3	Indonesia	0.1

Source: ONS Pink Book

Given the policy distortions affecting bank lending which are biased towards state-owned enterprises, capital markets (bond markets are also very under-developed) are needed to offer financing, particularly venture capital to support entrepreneurs and private firms which are credit-constrained despite the excess liquidity in the economy. The first 'dim sum' bonds have been issued (the very first was MacDonald's earlier this year) which are RMB-denominated corporate bonds issued in Hong Kong to try and raise money from China and entice Chinese savers to put their money somewhere other than housing and the stock markets.

Figure 8a UK stocks of direct investment abroad, 2009

£ millions

Source: ONS Foreign direct investment

Figures in brackets are percentage shares of total

Figure 8b Overseas stocks of direct investment into the UK

£ millions

Source: ONS Foreign direct investment

Figures in brackets are percentage shares of total

Hong Kong is the place where the Chinese tend to experiment. The 'dim sum' bonds and liberalisation measures extending only to Hong Kong are examples. Hong Kong has 50 years from 1997 to remain a separate economic entity. Its market development is likely to influence Chinese markets greatly, since the financial system is more developed and can positively influence regulation on the mainland. But, because of the gradual nature of Chinese reforms, experimenting in Hong Kong has limited cost especially since Hong Kong still has its own currency so any capital outflows will not affect the RMB. If it works in Hong Kong, then it has a greater chance of being introduced in China.

There is a catalogue of permitted investments by foreigners governed by various ministries, ultimately by the State Council, the highest governing body. The National Development Reform Commission (NDRC) is the highest policy body (they formulate the Five Year Plans) and tend to reveal the policy direction. But, politics and competition among ministries is fierce, which is often why statements can be contradictory. Also, provincial authorities are powerful, and decentralisation is one of the keys for successful Chinese growth, so they experiment and can ignore what the central government says is the criteria for foreign investment. This is unlikely to change as China develops, but more coordinated policymaking is one of the reform goals.

Chinese corporations and sovereign wealth funds are also likely to become more active investors in FDI. There are three sources of sovereign wealth funds

- CIC or China Investment Corporation are the official ones
- SAFE state administration for foreign exchange; and
- China Development Bank – one of the 3 policy banks spun off from the People's Bank of China (PBOC) when it became a central bank

They are trying to diversify China's capital outflows from its large holdings of US Treasuries by increasing overseas investments. In 2008, two-thirds of FDI was in financials and the rest in non-financials. With \$3 trillion in reserves, China will be diversifying more including funding its 'going global' policy.

Launched in 2000, the first ever commercial overseas FDI deal was struck in 2003/4 when TCL bought France's Thomson brand. This is the 'going out' of Chinese firms to make them multinational corporations. But the pace is slow. They are after what China does not have a comparative advantage in, which is unusual. But, they invest in technology, financial services, all areas where China seeks expertise. These are private firms, but with state connections because they need permission to invest overseas. Also, China is using its reserves to fund such investments which is controversial. But, as countries develop, it is not surprising that outward FDI will begin and multinational corporations form. It is also China's tool to liberalise the financial account but only through FDI. But, as they also want to internationalise the RMB (making it eventually into a reserve currency), it raises questions about whether they can achieve this objective without further financial account liberalisation.

Final remarks

China's trade has grown rapidly since it adopted its open door policy in the early 1990s and ascended to WTO membership in 2001. However, this has been largely concentrated in the global trade of manufactures, so whilst the UK is now importing more than ever from China exports of goods and services to China are yet to surge. For instance, compared to Germany and France the UK has been relatively unsuccessful in selling its wares to China.

China's continued growth is likely to see demand for consumer goods and services rise – the development of a services sector, especially in finance, may be an opportunity for the UK to deploy its comparative advantage in a new and growing market. However, restrictions on access to the Chinese market are likely to be removed slowly as China looks to protect its domestic firms from foreign competition and seeks to assimilate knowledge through joint ventures.

China's closed financial markets are also likely to be slowly deregulated. It is also likely that Chinese sovereign wealth firms and corporations are likely to look to acquire foreign FDI, in order to diversify reserves away from US Treasuries and as Chinese firms become increasingly mature and look to operate in global markets.

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