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The Impact of Brexit on Foreign Direct Investment and Trade Relations Between the UK and China

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12.1 Introduction

The main aim of this chapter is to identify the possible impact of Brexit on foreign direct investment and trade relations between the UK and China. The main research questions are: (i) How will Brexit affect Chinese foreign direct investment in the UK? (ii) Can the UK benefit from shaping new trade relations with China?

A study of a potential Brexit effect on selected aspects of the global economy must be reduced to some general considerations due to a wide range of possible Brexit scenarios and possible developments that are difficult to predict even for the parties directly involved. It is even more difficult to make predictions regarding the UK's future relationship

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with non-EU countries. The intended process of departure from the European Union is planned in two steps. The first stage of the "divorce" is related to the new EU-UK relationship. This will in due course affect Britain's relationship with non-EU countries, including in trade and investment.

The research methods used for answering the research questions are a literature review and a quantitative analysis of statistical data on trade and investment. Research reports and news articles on Brexit naturally focus on the UK. This imposes a skewed way of thinking about the future of British-Chinese trade relations: what are the strengths and weaknesses of the British economy, and how will the country's future relationship with the EU affect these strengths and weaknesses. A bit neglected—but potentially just as important—factor is the shape of future relations between the EU and China and its impact on UK-China relations. In fact, we are dealing with a triangle relationship, with each side affecting the remaining two. In the simplest terms, the EU will become a competitor for the UK in a different way than before. Moreover, the rest of the EU will be a more important partner for China, so the British-Chinese relationship may be somehow secondary to EU-China relations. Given the significant UK contribution to the current EU policy towards the Middle Kingdom, the divergence between what the EU and the UK are striving for is likely to deepen, especially in terms of a free-trade agreement, market economy status and an investment agreement.[1] Another factor limiting the freedom of shaping the future relationship will be relations with the USA.[2]

This chapter is organised as follows. The first part discusses the implications of Brexit for Chinese foreign direct investment in the UK. The next part focuses on the exchange of goods and trade in services. It analyses Eurostat data on exports and imports and offers an

[1]Summers, Tim, *Brexit: Implications for EU-China Relations*, Royal Institute of International Affairs, Chatham House, 2017.

[2]Summers, Tim, *Brexit and the UK's China Challenge*, https://www.chathamhouse.org/expert/comment/, 2016.

analytical concept to compare the structure of trade with and without trade restrictions. On the basis of this analysis, possible scenarios are developed. The last part concludes.

12.2 The Impact of Brexit on Chinese OFDI in Europe

Since the beginning of the 2000s, China's outward foreign direct investment (OFDI) has been growing rapidly, making the country the world's third-largest source of FDI (UNCTAD/WIR 2017). Europe attracted Chinese FDI motivated mainly by strategic asset seeking, i.e. brands, technology, know-how, R&D infrastructure and distribution channels through which Chinese firms improved their competitiveness in the global and domestic markets. Another benefit was access to the EU market, which is the number one recipient of Chinese exports and the largest market in the world. In 2016, the highest growth in the value of Chinese investment transactions in the EU28—compared to the annual average for 2013–2015 period—was recorded for industrial machinery and equipment, ICT, utilities, transport and infrastructure.

Within the EU, the UK has been the largest recipient of Chinese outward FDI, followed by Germany, while also serving as an investment base for Chinese investment in other member states (Hanemann and Huotari 2017).

Chinese investors in the UK are particularly interested in real estate (44% of the total value of deals between 2012 and the first half of 2016), energy (7%), finance (8%), health care (5%), agriculture, technology and entertainment industries (American Enterprise Institute and the Heritage Foundation 2017; Kynge 2017). High Chinese investment in British real estate is a result of Chinese businesses' motivation for safe placement of their assets. In the 2016–2017 fiscal year, the number of FDI projects carried out by Chinese investors as well as the number of newly created jobs increased compared with the previous year (UK Trade and Investment Inward Investment Reports 2017). It is important to note that the number of Chinese FDI projects in the UK in the period 2016–2017 was higher than in the preceding years despite restrictions on outward FDI introduced by the Chinese government at the end of 2016 (which was a record year for Chinese OFDI, seeing it grow by 30% in year-on-year terms to USD 188.8 billion). The restrictions were motivated by falling value of country's currency (Renminbi) and decreasing foreign exchange reserves (Davies 2016; Ernst & Young 2017). In 2016, the UK ranked fourth globally in terms of Chinese M&As (Liu 2017). In terms of the number of Chinese M&A deals in the EU, the UK has been leading the way, implying a strong interest in strategic assets and much less interest in market expansion through FDI (Clegg and Voss 2012). This is confirmed by OECD findings that China supplies the UK mainly by trade as opposed to the USA, France, the Netherlands and Japan, which do so through trade and sales by foreign affiliates (OECD 2017). Chinese investors are not only owners of renowned UK brands such as House of Fraser, MG Rover, Pizza Express and Weetabix (Voss 2017), but they also invest in R&D centres benefitting from specialised clusters, such as Sinovet, which in 2015 established a new animal health R&D facility near Edinburgh (UK Trade & Investment 2015).

Based on the above, it can be inferred that Chinese investment in the UK will not be greatly affected by Brexit as their motivations are mostly related with securing assets (real estate investments) and strategic-assets seeking. In fact, British firms became cheaper for Chinese businesses as the British pound lost value against the Chinese Renminbi: falling from 9.43 on the day of referendum to 8.97 in May 2017 and 8.76 in November 2017. Meanwhile, the euro gained more than 5% over that time, as a result of which euro-denominated assets became more expensive for Chinese investors (Voss 2017). The number of newly announced M&A deals dropped by 20% in the first six months of 2017 compared with the same period in 2016 (Hanemann and Huotari 2017). The slowdown in Chinese corporate FDI might be explained by a wait for further devaluation and better deals. Chinese motivations after Brexit will remain the same, notably a search for prominent brands and cutting-edge technologies. Chinese market-seeking firms that target the whole EU market will most probably lose interest in the UK.

12.3 The Impact of Brexit on Trade Relations Between the EU, the UK and China

Worthy of mention are the British government's assumptions about the rules shaping future trade policy, in particular the pursuit of high consumer, employee and environmental protection standards in trade agreements.[3] Too many requirements in these areas might limit the freedom to form relationships with China. Finally, it is worth mentioning the Belt and Road Initiative (BRI), an important aspect of Chinese policy in which Britain plays a rather marginal role. This limited involvement may hamper negotiations on trade relations.[4]

All these issues will be crucial for UK-China trade in the long term. Meanwhile, in the short and medium term, two macroeconomic developments will affect trade. The weakening of the pound has already made British exports cheaper and imports from China have become more expensive. This effect has been changing trade flows ever since the Brexit referendum. Second, as rightly noted in Rothman 2016, a broader anxiety over Brexit may induce a material economic downturn in both the EU and Britain.[5] That would affect both the size and composition of trade with China.

For the UK, China was in 2015 the fourth-biggest recipient and second-largest seller of goods, constituting 5.9 and 9.9% of total British trade flows respectively. With respect to services, China was in third and seventh place respectively (1.4 and 1.0% of the total). It is worth noting that Hong Kong is also a major partner in the trade of services.[6] In goods trade, China is one of the main partners, but its role in the exchange of services is less significant.

From China's point of view, the UK is a less significant partner. In the trade of goods, the UK is the ninth largest export market (2.6% in

[3]Department for International Trade, Preparing for Our Future UK Trade Policy, p. 29, October 2017.

[4]Brown, Kerry, *How Brexit Britain Can Gain from China's Belt and Road*, http://www.scmp.com/week-asia/opinion/article/2094166/what-brexit-britain-has-gain-chinas-belt-and-road, 2017.

[5]Rothman, Andy, *Brexit Impact on China*, Advisor Perspectives, 2016.

[6]Based on comtrade.un.org.

2016) and the 20th largest import market (1.2%) for China.[7] This disparity may be an important factor shaping the future trade relationship between the countries.

Future commercial relationships within the triangle will be shaped by the relative role of the UK and other EU member states in trade with China. In this context, it can be noted that the UK is China's second-largest export market in the EU. The share of the UK in the trade of goods was 16.7% in 2015, lower than Germany's and equal to that of the Netherlands. It can be concluded that the position of the UK is important in this dimension. Meanwhile, Britain's role in exports from the EU to China is less significant. The UK was the third-largest exporter in 2015, with a share of 9.2% vs. Germany's more than 42%.[8] This considerable disproportion has been cited as a confirmation that Britain has untapped potential that could be released by greater freedom in shaping trade regulations after Brexit. In terms of the total EU deficit in goods trade with China, the UK is in second place, with a share of 27% vs. Germany's 34%.

The dynamics of the trade relationship (in the exchange of goods) between China and the UK is ambiguous. During the 2010–2015 period, UK imports from China increased by about 53.7%, vastly outperforming the dynamics of the remaining EU countries (8.2%).[9] The same is true of exports where the respective figures were 67.5 and 19.6%. Britain compares unfavourably with other EU countries in terms of the trade deficit. In the case of the UK, the trade deficit increased by close to 50% from 2010 to 2015, while in other countries it fell by 7%.

Other EU countries can be a point of reference for analysing British trade. However, for the full picture, it is worth taking a look at Switzerland, a country whose status is similar to that Britain may obtain after leaving the EU. Switzerland maintains close relations with the EU as a member of EFTA, and at the same time, it is free to negotiate trade

[7]Based on info.hktdc.com.

[8]Own calculations based on stats.gov.cn.

[9]Own calculations based on www.stats.gov.cn.

agreements with third countries separate from the EU. Switzerland has signed 38 such agreements, including one with China.[10] Such a scenario is viewed as potentially beneficial for British exports.[11] For China, the ability to negotiate agreements with European countries independently of EU policy may be a bargaining point in negotiations with the EU, which could potentially allow the UK to secure favourable conditions.[12] Data on trade between Switzerland and China appears to validate such a scenario. Switzerland has a surplus in goods trade, with exports growing by more than 140% from 2010 to 2015 and slow growth of imports. However, the freedom to shape the trade relationship is not the only factor that plays a role. Another important factor is a growing tendency among rich Chinese citizens to buy luxury goods.[13]

The freedom to shape future business relationships will influence UK-China trade insofar Britain's potential is limited by the current EU-China agreement. The extent of limitations resulting from the current regulations and potential changes that may be prompted by Brexit can be analysed in many ways. Below an attempt at a quantitative approach to trade is presented. It is based on an analysis of the current structure of British exports.

The approach applied in the analysis is based on the following reasoning. The starting point is two countries trading under completely unrestricted movement of goods. The structure of commodity exports of one of them to the other is a result of a number of factors, such as the characteristics of the two economies, mutual comparative advantages and geography. Then trade policies are changed and trade is no longer completely free. The likely result of this change will be an adjustment of trade flows. This will probably happen even if the conditions

[10]What consequences would a post-Brexit China-UK trade deal have for the EU?, p. 3, Policy Contribution Issue 18, 2016.

[11]Winders, Sam, *Would a Post-Brexit UK Be Better Able to Sign Free-Trade Agreements with the Rest of the World?* The Bruges Group, 2016.

[12]Summers, Tim, *Brexit: Implications for EU-China Relations*, The Royal Institute of International Affairs, Chatham House, 2017.

[13]For example, the value of watch exports alone (expressed in CHF) increased by about 22% in 2010–2015, or nearly USD 250 million, according to the Federation of the Swiss Watch Industry (FH).

for all items (e.g. uniform customs tariffs) undergo the same changes because the same percentage change in prices does not necessarily cause the same changes in demand in different groups of products. As a result, this changes the structure of the flows. The discrepancy between the initial structure and that following the introduction of restrictions on trade reflects the strength with which the new rules distort trade.

This analytical concept was applied using Eurostat data on British exports in 2016, broken down according to the HS2 nomenclature (around 100 product groups). The structure of trade with China conforms to the revised structure described in the example above. Data on the structure of trade without barriers is obviously unavailable. So an approximation was used for the purpose of this analysis. To simplify the analysis, it can be assumed that the flow of goods within the EU is free, so the structure of Britain's trade with the EU can be used as a point of reference (reference structure)—with certain limitations, as discussed later. The degree of divergence of both structures was determined as follows. For individual commodity groups, the difference in participation in the structure of exports to China and EU countries was determined. The average absolute differences, expressed in percentage points, show the discrepancy between the structures and, by extension, the level of trade distortion:

$$ix = \sum_{i=1}^{n} |s_i - r_i|/n$$

where *ix* denotes the divergence measure index; *n*—number of classes of goods; r_i—share of the *i*-th class of goods in the initial (reference) structure; and s_i—share of the *i*-th class of goods in restricted trade conditions.

In order to determine whether the obtained effect is large or small, a scale is needed. It should also be noted that trade flows, and thus also their structure, may be a result of factors other than the free movement of goods and its restrictions. As a point of reference, analogous indicators for each of the remaining EU countries were used. Any differences between them are due only to the diversity of economies and not the regulation limiting the freedom of trade. For the calculation of these indicators, a modified reference structure was used, determined based

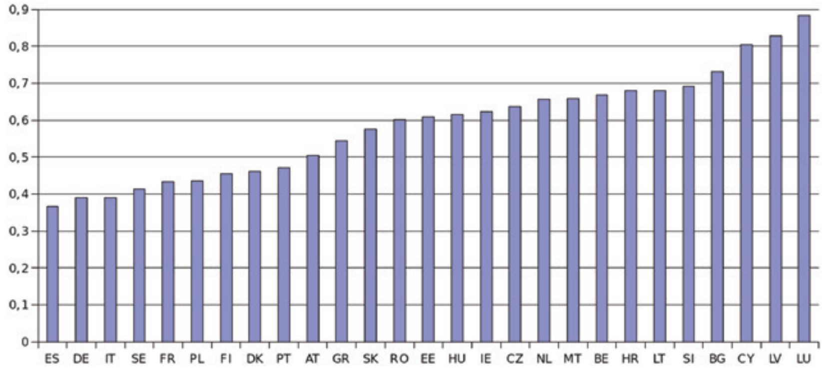

Fig. 12.1 Indicators of structural discrepancy for UK exports to EU countries (*Source* Own calculations based on Eurostat data)

on British exports to EU countries other than the one for which the indicator was calculated. This is due to the fact that large importers have a significant contribution to trade with the EU as a whole and that the value of the indicator would be underestimated.[14] It can be expected that the values obtained by the EU countries will usually be lower than that for China, which results not only from the different nature of the economy but also restrictions on the free movement of goods. The figure below presents the discussed indicators. They range from 36 to 87%, and the larger countries frequently have lower indicators. It can be assumed that this is a consequence of the higher diversity of large economies, more resembling the sum of all EU economies bar the UK. As a result, the weighted average value of the indicator (with the size of British exports to a given country as a weight) is 0.55 p.p., and the arithmetic mean is 0.59 p.p. (Fig. 12.1).

In other words, a large and relatively diverse economy should, under free trade, have an indicator of discrepancy for British exports ranging from 0.37 p.p. to around 0.50 p.p. A higher value may indicate that the existing restrictions on the free movement of trade distort the structure of British exports and suggest the potential for a correction in the case

[14]In other words, for example, in Germany we would compare the structure of German trade with one in which German trade constitutes a significant part.

of free trade post-Brexit. The indicator calculated for China is 0.63 p.p. and so suggests the possibility to improve the matching of trade after the UK leaves the EU.

One can, however, rightly argue that the factors driving British-Chinese trade are in some respects different from those affecting the exchange of goods with the EU and that the differences are not limited to a lack of freedom of trade. Above all, the cultural and geographic conditions are different. The cultural conditions affect the structure of demand from China regardless of free trade, and the geographic conditions make some imports from Britain unprofitable for China, although they are cost-effective for European partners. For these reasons, it is worth analysing the indicators of discrepancy for UK exports to China compared to other non-EU countries (Fig. 12.2).

The indicators range from 0.48 p.p. for Canada to 1.52 p.p. for Switzerland. It is worth noting that not only Canada, but also Australia and the USA have relatively low indicators, below that of China. This can be attributed to cultural and linguistic proximity, which partly compensates for the distortion of trade resulting from geographical factors or restrictions on the free movement of goods. India, a country with lower income, but huge potential and a population comparable

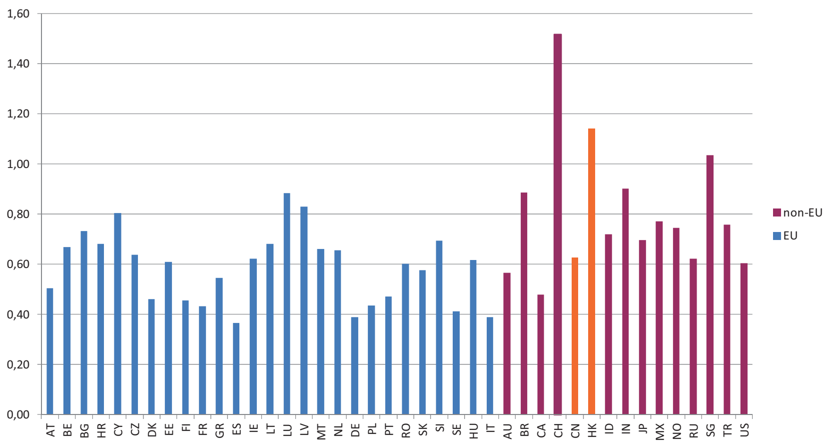

Fig. 12.2 Indicators of structural discrepancy for UK exports to EU and selected non-EU countries (*Source* Own calculations based on Eurostat data)

to that of China, has an indicator of 0.72 p.p. Indonesia, Japan and Brazil also have relatively high indicators. Against the background of all these countries, China's indicator is relatively low, pointing to a limited impact of restrictions on freedom of trade and less potential for a revolution in commercial trade flows because of Brexit. So the benefits of a free-trade agreement with China will at best be modest.[15]

Hong Kong is a different case. Its indicator of 1.14 p.p. may come as a surprise given that just two decades ago the economy was controlled by Britain. However, in this case, the key issue is that Hong Kong is a small economy with a relatively high income per capita. Singapore is another country with similar characteristics (a small Asian city-state with high income per capita) and an indicator of 1.03 p.p.

While this chapter has focused on trade in goods, it is often emphasised that the strength of the British economy lies in services and that the trade of services holds the greatest potential for development after Brexit. The UK is a powerhouse in services such as finance and education, and China is increasingly moving from manufacturing to services. When negotiating free-trade agreements, the European Union must balance various conflicting interests among EU member states, which impairs the free movement of services. However, the argument about the complementarity of China (exports of labour-intensive goods) and the UK (exports of high-tech goods and services) is only seemingly rational. It is worth asking whether this argument is based on a realistic assessment of comparative advantages as China evolves from a low-cost economy to a provider of advanced technology. Such a transformation may help boost British exports in the short term, but in the long run it may prove to be a threat.

The development of services, including financial services, will further deepen the divide between London, which values the country's EU membership, and the rest of Britain.[16] The development of educational

[15] What consequences would a post-Brexit China-UK trade deal have for the EU?, p. 8, Policy Contribution Issue 18, 2016.

[16] Dreyer, Jacob, *Could China Be the New Best Friend for a Post-Brexit Britain?* https://www.newstatesman.com/politics/economy/2017/07/could-china-be-new-best-friend-post-brexit-britain, 2017.

services may be in conflict with the expectations of Brexit supporters and calls to reduce immigration. In context of British service exports, it seems puzzling that there has been little mention of the possibility of the UK wrestling a chunk of the Chinese market away from other partners. Rather, it seems that new demand is expected to appear in China matching what the UK has to offer in various sectors.

12.4 Conclusions

The UK's decision to leave the European Union means that the two partners will have to redefine their political and economic relations. The actual form of divorce between the EU and the UK, either a "soft" or "hard" Brexit, will have significant repercussions for their relations with other major global partners such as China. Despite an initial shock caused by Brexit, it seems that it will have little effect on economic relations between the UK and China. Chinese investors in the UK are attracted by safe investments in real estate and strategic assets, which became cheaper after the British pound took a hit. Meanwhile, other EU locations offering such strategic assets became less appealing as the euro appreciated.

It is often emphasised that British-Chinese trade will benefit from the UK's ability to reshape its international relations, but the common view is that any resulting changes will not necessarily be beneficial in all areas. While the potential for deepening and expanding trade is undoubtedly in evidence, there are many doubts as to whether it is sufficient and whether it can be exploited in the right way. The definitive shape of relations between the EU and a post-Brexit Britain and between the EU and China will be crucial. The quantitative analysis indicates that, although there is potential for the development of UK-China trade, it is probably not as large as is often claimed. The argument for expanding the trade of services is based on factors including the complementarity of what the UK and Chinese service sectors have to offer. But it is uncertain how long this complementarity can last.

It is frequently argued that a post-Brexit UK will be more nimble and free-trade-oriented, which will result in better trade relations. However, it is worth remembering that, for the quality of trade relations, it is equally important to what extent the other side is free-trade-oriented at the same time. Despite frequent declarations (including by Chinese President Xi Jinping at Davos), China's dedication to free trade is unbalanced. It is skewed towards unhindered trade in China-produced goods. So changes in UK-China trade resulting from Brexit may prove to be less significant than theoretically possible.

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