IV – Outlook for UK-Chinese Economic Relations: Opportunities for Higher Growth

Introduction

The Chinese economy is booming. As the economy has grown rapidly, China's trade and investment relations with foreign countries, including the UK, have soared. But what are the most recent trends in trade and investment between the UK and China? Are there any problems? What are the opportunities for British companies to reap increased rewards from China's rapid economic growth?

This article addresses these questions. It is structured as follows:

- Section IV.1 describes the growing significance and changing structure of the Chinese economy;
- Section IV.2 analyses current trade relations between the UK and China;
- Section IV.3 assesses UK-Chinese investment flows;
- Section IV.4 identifies capabilities of the UK economy that can be of value to China, and reviews the major business opportunities created by China's sweeping economic reforms and market opening programme; and
- Section IV.5 draws conclusions from the analysis.

IV.1 – The rise of the Chinese economy

China is becoming an increasingly important global economic power. The size of its economy, as measured by GDP at current market exchange rates, reached a record level of around US$1.4 trillion by 2003. On this basis, China ranks sixth in the world, after the US, Japan, Germany, the United Kingdom and France (see Table 4.1). In terms of GDP at purchasing power parity (PPP)[1] exchange rates, China is already the world's second largest economy, behind only the US.

Table 4.1 – Largest economies in the world (2002)

Top 10	GDP at current market exchange rates (US $bn)	Top 10	GDP at PPP exchange rates (US $bn)
1. United States	10,416	1. United States	10,138
2. Japan	3,979	**2. China**	**5,732**
3. Germany	1,976	3. Japan	3,261
4. United Kingdom	1,552	4. India	2,695
5. France	1,410	5. Germany	2,172
6. China	1,237	6. France	1,554
7. Italy	1,181	7. United Kingdom	1,511
8. Canada	716	8. Italy	1,481
9. Spain	650	9. Brazil	1,311
10. Mexico	637	10. Russia	1,141
World Total	**32,252**	**World Total**	**47,426**

Source: World Bank

Over the past decade, China's economic growth rate has been among the highest in the world, rising by an average of around 8% per annum. In 2003, the economy expanded by an estimated 9.1% – the highest in seven years – due to rising fixed investment, booming foreign investment and trade, and strong domestic demand. If China can maintain this pace of development, it is poised to overtake Britain and France to become the world's fourth largest economy (based on GDP at market exchange rates) before the end of 2005.

After 25 years of economic reform, accelerated by the country's accession into the World Trade Organisation (WTO) in December 2001, China's economic landscape has been transformed from a centrally planned economy to a "socialist market economy." Today, around two-thirds of China's GDP is generated by the non-state sector, compared to less than 20% in 1978.

The change is even more dramatic on the external front. China's foreign trade (i.e. the total value of exports and imports), following a decade of double-digit growth, surged by an estimated 37% year-on-year in 2003 to US$851 billion, making China the world's third largest trading nation after the US and Japan. China's openness ratio (the value of exports plus imports relative to GDP) has increased from virtually nothing at the beginning of the reforms in the late 1970s to nearly 50% by 2003. China has also attracted high levels of foreign direct investment. Statistics of the Ministry of Commerce (MOFCOM) show that China's total stock of actual foreign direct investment amounted to just over US$500 billion at the end of 2003, with around 465,000 foreign companies operating across the country. Foreign-invested companies now account for 54% of China's exports, 33% of its industrial value added and 21% of Chinese government revenue. More than 23 million Chinese work directly in foreign-invested enterprises, accounting for around 10% of the country's labour force.

As foreign investment has poured into the country and the private sector has mushroomed, China has become a "manufacturing hub of the world." According to The Economist's World in Figures 2003 directory, China is now the world's largest manufacturer of textiles, garments, footwear, steel, refrigerators, microwave ovens, televisions, radios, toys, office products and motorcycles. Chinese products, with lower prices and of reasonably good quality, are conquering world markets, although this has caused increasing concerns, especially from the US but also within the UK, about losing domestic manufacturing (and perhaps in future also services) jobs to China.

[1] PPP exchange rates adjust for the fact that price levels of non-traded goods and services are generally much lower in an emerging market economy such as China than in developed OECD countries. GDP at PPP exchange rates therefore provides a better indication of the relative volume of output produced in these different economies. In the long run, market exchange rates might be expected to move towards PPP rates.

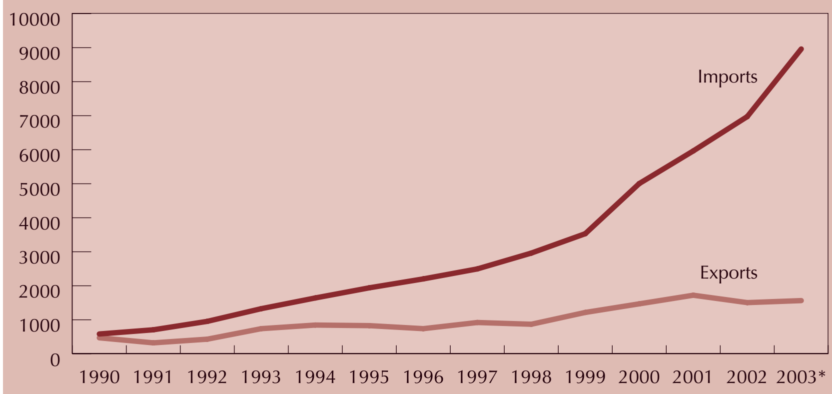
IV.2 – UK-Chinese trade relations

Bilateral trade relations between the UK and China have developed rapidly, with the total value of trade in goods surging from US$764 million in 1980 to US$11.4 billion in 2002.

As Figure 4.1 shows, bilateral trade growth has been particularly strong over the past five years, but UK imports from China have outpaced UK exports to China by a significant margin. The Chinese share of total UK imports rose from 1.5% in 1998 to over 3% in 2002, while China's share of UK exports only edged up from 0.5% to nearly 1% during the same period (see Figure 4.2).

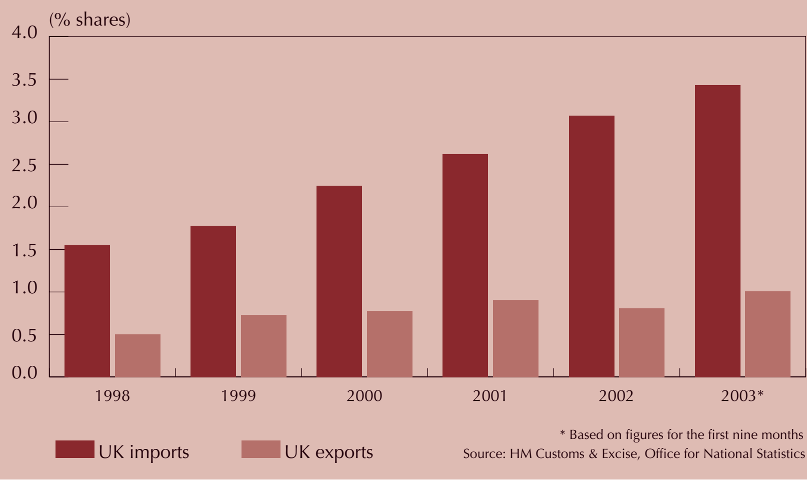
According to official Chinese statistics, UK imports from China in 2002 rose by 18.9% year-on-year to US$8.1 billion, while UK exports declined by 5.4% from a year earlier to US$3.3billion, leaving the UK with a widening trade deficit with China. These trends continued into 2003. In the first ten months of 2003, the total value of UK-China trade increased by 21% year-on-year to US$11.4 billion. But UK imports from China jumped by 28.5% from a year ago, while exports to China rose by only 3.9% during the same period, according to MOFCOM statistics.

Figure 4.1 – UK trade in goods with China (value: £ million)



* Denotes estimates by PwC based on MOFCOM annualised growth rates in the first ten months of 2003
Source: HM Customs & Excise, Office for National Statistics

Figure 4.2 – Chinese share in UK's total imports and exports



* Based on figures for the first nine months
Source: HM Customs & Excise, Office for National Statistics

UK imports from China are mainly labour-intensive manufacturing products, such as electrical machinery & appliances, office equipment, communications and sound recording apparatus, textiles and clothing, toys, shoes and furniture. In contrast, UK exports to China are mainly resource and/or technology-intensive products such as petroleum and related products, specialised industrial machinery, power generating machinery & equipment, medical and pharmaceutical products, and professional, scientific & control instruments.

Despite the rapid growth in bilateral trade, the UK has fared less well than many of its European competitors in terms of both overall trade values and growth rates. For example, UK's total trade value with China in 2003 was the third highest among the EU countries, but was still only around a third of that of Germany and 6% less than that of the Netherlands, and the UK's bilateral trade growth rate in that year was only around half the EU average. Meanwhile, China, the fourth largest export market of the EU in 2003, is only the tenth largest trading partner of the UK, accounting for around 2% of UK's total imports and exports. The UK accounted for less than 2% of China's international trade in 2003. In this context, there is still great potential for further developing trade relations between the two countries.

IV.3 – UK-Chinese investment flows

The UK has historically been the leading European investor in China, with over 3,400 British-invested joint ventures and a cumulative total investment estimated at around US$10.7 billion. In 2002, actual British direct investment stood at US$896 million, making the UK the second largest European investor in China after Germany, in that year, as indicated in Figure 4.3.

In the first eleven months of 2003, 387 new British ventures were set up in China with a total contractual value of US$1.07 billion, rising by 15% from a year ago. But the actual investment made has been less impressive, standing at US$0.68 billion, down by 10.7% year-on-year following a decline of 15% in 2002 as UK's overall outbound investment had declined.

Most of the UK investment in China is made by large companies such as BP, Shell, BOC, Rolls-Royce, BT, Unilever, GlaxoSmithKline, Standard Chartered, Prudential, Thames Water, Arup and Kingfisher. More recently, some smaller British operators with specialised knowledge have also entered, or are planning to enter, the market. China's low production costs, huge and booming domestic market, as well as increasing internal pressures for UK companies to have a commercial presence in the region are the key driving factors behind this investment.

Despite the long-term rising trend in UK-Chinese investment links, there is still room for significant further development. Currently, China accounts for just 4% of UK's overseas investment, while UK contributed only 1.7%

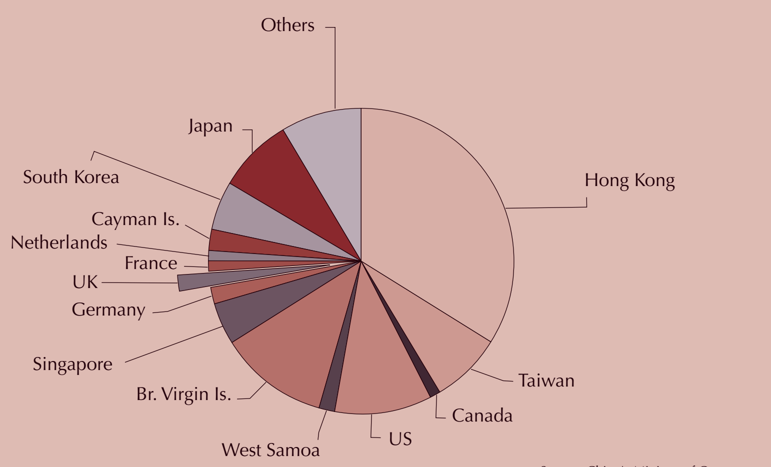
of total foreign direct investment in China in 2002. According to the latest Chinese statistics, the UK was not one of the top ten foreign investors in China in 2003, which were Hong Kong, British Virgin Islands, Japan, South Korea, the United States, Taiwan, Singapore, West Samoa, Cayman Islands and Germany[2].

Instead of a one-way flow of funds, an interesting development in recent years is that an increasing number of Chinese companies are now starting to invest in the UK, spurred by the Chinese government's new policy of encouraging Chinese enterprises to expand overseas. According to MOFCOM, more than 2,300 Chinese companies have been established in 128 countries with a total stock of investment of over US$30 billion by the end of 2002. Chinese investment into the UK also recorded significant growth in 2002 with 22 new investment projects, bringing the total number of mainland Chinese investors in the UK to around 60[3]. While most Chinese companies are engaged in trading, banking, insurance and travel services, newer functions such as sales, R&D and European headquarters have been added to the list. An indicator of this developing trend is that the Industrial and Commercial Bank of China (ICBC), China's largest commercial bank, decided to upgrade its representative office in London to a branch office in 2003. The Bank of China, meanwhile, has expanded its branches to cover four major UK cities.

IV.4 – Future growth opportunities

Looking ahead, there is huge potential for growth of bilateral relations between the UK and China. On the political front, UK-China relations are at present "in one of the best periods of development in history," in the words of Chinese leaders[4]. Improved political relations have created a fertile ground for business, but UK-Chinese trade relations have nonetheless been growing at a slower rate compared to those between China and the US, Japan and other major European countries such as Germany.

Figure 4.3 – Major foreign investors in China in 2002 (% shares)



Source: China's Ministry of Commerce

In fact, the UK has a great deal to offer China. The UK's highly developed financial system, rich experience in privatisation, highly skilled labour force and strong capabilities in telecommunications, energy, transportation, chemicals and petrochemicals, and food processing are all of great interest to China. UK companies could find a huge Chinese market in fields such as environmental and pollution control, healthcare, agri-business management, financial and legal services, information technology, education and training, hydropower and forestry.

China's fast-growing economy and its continued economic reform process will also provide enormous business opportunities for UK companies. Two years after WTO entry, China is now undergoing profound economic restructuring in accordance with its WTO commitments. In the process, it has created unprecedented opportunities for foreign businesses. For example:

- **Trade regime** – China's customs tariffs have been reduced from an average of 15.3% in 2000 to an average of 10.4% on 1 January 2004. Industrial tariffs will be reduced from an average of 10.6% to 9.8% and agricultural tariffs will be reduced from 17.4% to 15.8% by the end of the year. Zero tariffs will be applied to a significant proportion of IT products. Non-tariff measures such as import quotas have been scaled back to only a few limited bulk commodities, and non-state trading in special commodities such as oil and petrochemical products will have a higher percentage quota. Joint ventures with majority foreign ownership will gain automatic foreign trading rights, and thresholds for domestic Chinese companies to have foreign trading rights have been lowered to RMB 1 million ($120,000). Geographical restrictions for foreign operations in China have been eased, and the remaining ones are to be phased out in two to three years time.

- **Investment regime** – The compulsory requirements on foreign-invested enterprises in terms of proportion of local resources, export proportions, foreign exchange balance, share-holding proportions and technology transfers have been, or will soon be, phased out. The State Council is now drafting its "investment regime reform initiative," which, once implemented, will greatly streamline the current detailed administrative approval process over project proposals and feasibility studies of foreign investment. Additional economic sectors that were previously off-limits to foreign investors will be opened to foreign participation; these include sectors such as telecommunications, banking, insurance, securities and retailing, as well as restructuring of state-owned enterprises and rejuvenation of the old industrial bases in northeast China.

[2] The high value of foreign investment from tax havens such as the British Virgin Islands and the Cayman Islands, and including a significant portion of investment from Hong Kong, reflects the fact that they are often just transit sites for investment originating elsewhere, in particular from China itself, where foreign investment enjoys more preferential treatment than investment by local companies.
[3] Depending on the source of information used, there are different figures regarding the total number of Chinese companies operating in the UK. A DTI report suggests there are 180 Chinese companies operating in the UK. London First, on the other hand, says there are approximately 190 Chinese companies in London alone, of which around 130 are from Hong Kong. The website of China's Commercial Office in London lists only around 35 Chinese companies.
[4] Speech by Vice Premier Wu Yi at the annual conference of the China-Britain Business Council held in London on 13 May 2003. Similar views were also expressed by the visiting Chinese President Hu Jintao and Premier Wen Jiabao.

- **Consumer markets** – As the economy grows, China's GDP per capita (at current market exchange rates) broke the barrier of US$1,000 for the first time in 2003. The average disposable income of urban residents rose by an estimated 9.3% to RMB 8,500 ($1,036), while that of rural residents climbed by 4.3% to RMB 2,622 ($390). Rising income levels have triggered higher demand for consumer goods. In 2003, China's housing sales rose by 40% year-on-year; automobile sales shot up by 92.8% with over two million sedans sold; and the number of new telephone users grew by 112 million, equivalent to the combined population of Britain and France. Meanwhile, an increasing number of Chinese are traveling abroad, spending more than US$20 billion overseas in 2003. The World Tourism Organisation predicts that China will be the country with the largest number of outbound tourists by 2020.

- **Energy** – Rapid economic growth has made China the world's second largest importer of oil after the U.S. in 2003. According to the International Energy Agency, China is likely to import around 80% of its oil supplies by 2030, as compared with 35% in 2000. Furthermore, China's power sector has hardly been able to cope with rising demand and the state had to ration electricity supplies to most parts of the country last year. The Chinese government has therefore stepped up its efforts to construct more natural gas pipelines, enhance its power generation and distribution capacities, buy more foreign fields and exploration and development rights and further deregulate its power and natural gas sectors. Foreign companies, including those from the UK, should benefit significantly from this process.

- **Telecommunications** – China's telecoms market has grown by an average of 28% per annum since 1997 according to Ministry of Information Industry statistics. By the end of 2003, China had the world's largest number of telephone users, with 268.7 million fixed line users and 263.3 million mobile customers. The number of Internet surfers in China jumped by around 35% in 2003 to just under 80 million, ranking second in the world after the US. The number of computers connected to the Internet reached 31 million by the end of 2003, up by 48% from a year ago. Explosive growth in China's telecoms and web population has translated into high profits for both domestic and foreign manufacturers and service providers. Future market potential remains huge, as indicated by recent orders of telecoms and computer equipment worth US$2.3 billion signed by a visiting Chinese purchasing delegation to the US.

- **Financial services** – Boasting the world's second largest foreign exchange reserves at over US$400 billion in 2003 and huge national savings, China's financial market has attracted enormous interest from foreign financial institutions. In line with commitments made by China during its WTO accession negotiations, many new market-opening policies have been announced lately. In the **banking** sector, four new cities (Jinan, Chendu, Chongqing and Fuzhou) are now open to foreign banks and, in the previously approved cities, foreign banks are now allowed to engage in local currency services to Chinese corporations. The new banking management regulations have allowed foreign financial institutions to hold a stake of up to 20% in local Chinese banks. And the recent pumping of US$45bn of state reserves into two of the country's largest debt-ridden state-owned banks prior to planned IPOs later in the year will pave the way for more foreign involvement. For the **insurance** sector, foreign-invested property insurance firms were allowed from December 2003 to offer life insurance policies including emergency and short-term medical coverage. Since WTO accession, 8 foreign insurers have been granted market access and another 17 have been approved to operate in China. To date, 36 foreign insurers have set up 57 insurance operations in the country, including 20 life insurers, 14 property insurers and two re-insurers.

Meanwhile, China's **stock markets** are also increasingly open to foreign participation, as more Chinese companies launch IPOs. In late 2002, China allowed foreign investors to buy controlling stakes in listed Chinese companies. Now officials at the State-owned Assets Supervision and Administration Commission are planning a wider sell-off of state assets. In 2003, Chinese companies raised around RMB136 billion (US$16.4 billion) of funds on domestic and overseas securities markets, an increase of 41% from 2002. The number of listed companies in Shanghai and Shenzhen rose by 63 to 1,287.

IV.5 – Conclusions

It is clear that China offers enormous business opportunities to foreign companies, but it is also facing many problems. The Chinese economy is in danger of overheating, particularly in the housing, automobile and related sectors, while the Chinese currency is facing increasing pressure from the U.S. for a revaluation that would also help to dampen domestic inflationary pressures. To cool off the economy, the Chinese government is contemplating reducing fixed investment and credit loans. This in turn, however, could aggravate the already serious problem of unemployment. Meanwhile, the de facto insolvent state banking system, loss-making state-owned enterprises, lax legal environment, widening regional and income disparities, and still significant political controls all pose challenges to foreign investors.

But the Chinese word for crisis, weiji, means both risks and opportunities. One's fate is determined by one's ability to grasp the opportunities while circumventing the risks. A country that is undergoing changes as dramatic as in China today is sure to provide many such challenges but also offers great opportunities.

The UK used to be the largest European investor in China, and the second largest European trading partner with China. But due to relatively slow growth, the former position was lost to Germany two years ago and the latter was taken over by the Netherlands last year. In fact, UK's strong capabilities in sectors such as financial and business services and telecommunications match perfectly with China's current weaknesses and future demand profiles. Making good use of these capabilities can further increase bilateral relations to the benefit of both countries.