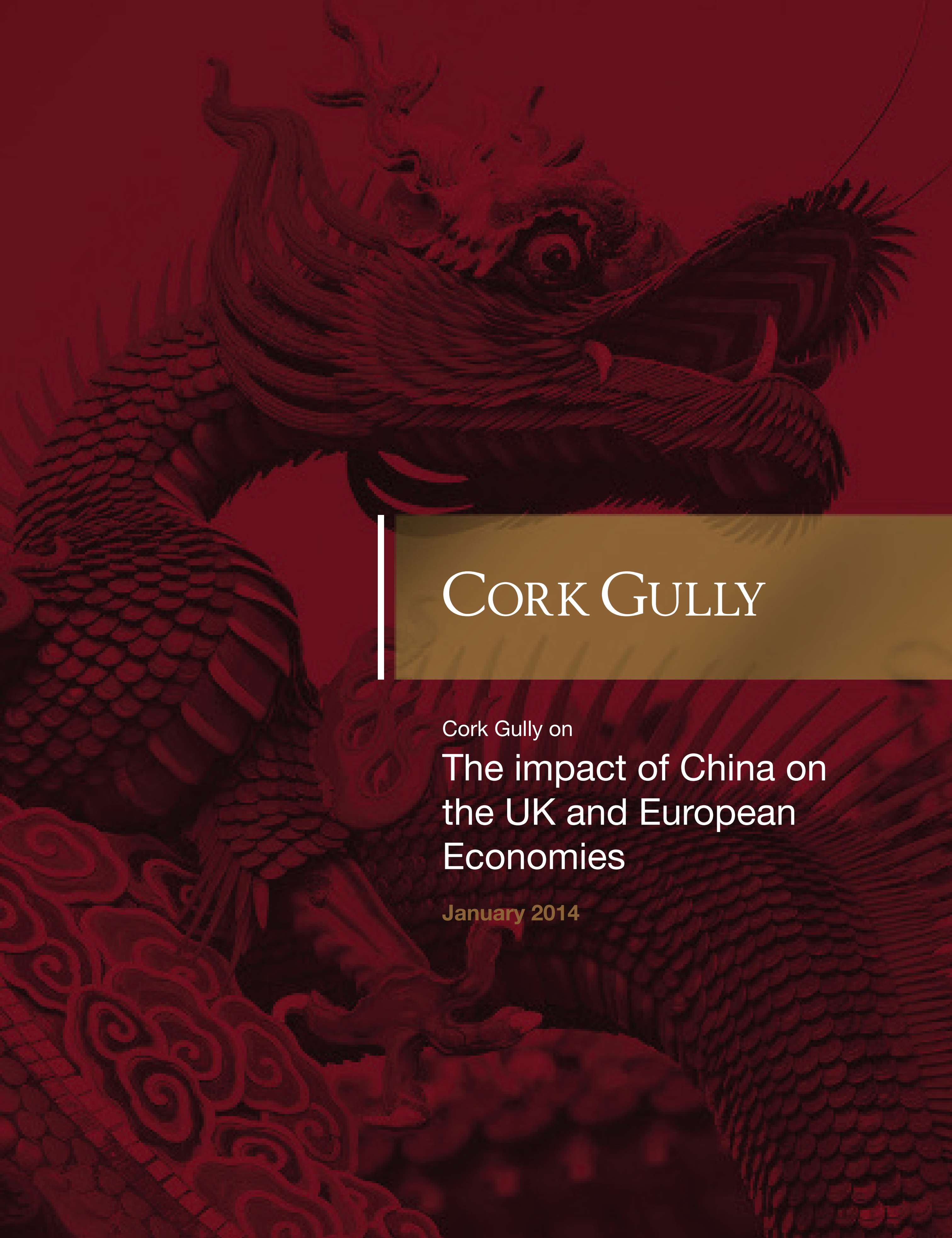

CORK GULLY

Cork Gully on

The impact of China on the UK and European Economies

January 2014

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Contents

Introduction

This report analyses trends in the relationship between the UK and Europe and China.

Since opening up to the world following a series of economic reforms instigated under the stewardship of Deng Xiaoping in the 1970s and 80s, China has pursued a textbook policy of export led growth which has seen its economy rise from just 2.8% of global GDP in 1980 to stand at 12.2% in 2013. And while the Chinese economy has already begun to ease back from the double-digit growth it has realised over much of this period, even a slowing China stands to far outpace advanced economies over the coming decade.

Such a dramatic transformation in the global landscape, on a scale which eclipses even that of the industrialisation of Western nations in the 18th and 19th centuries, has inevitably had a marked impact upon both the UK and the rest of Europe. Initially this could be seen in the influx of low-cost textile and manufactured goods, made possible by the relative cheapness of Chinese labour. The continued industrialisation of the Chinese economy has seen China's appetite for commodities accelerate rapidly, pushing up global demand and ultimately raising the prices of many raw materials.

Throughout the course of China's development saving has remained elevated as the economy has yet to adjust to Western style patterns of consumption. The sheer scale of China's transformation means this has noticeably altered the quantity of investable funds in the global financial system. The increase in Chinese savings on the world stage has been instrumental in bringing down the costs of borrowing in Western economies, which in turn played a role in fuelling incentives to pursue the risky investments which preceded the financial crisis in 2007.

More recently, a slowing of growth in China, and indeed in many emerging markets, has started to relieve upward pressure on commodity prices, resulting in a more benign outlook for inflation across the globe. Meanwhile, the expanding middle class in China has stoked increased demand for more luxury items, providing greater opportunities for the UK and Europe to expand exports into the Chinese market. From luxury cars to financial services, the potential to capitalise on China's rising wealth is one of which Western economies are acutely aware.

Alongside rising wealth and economic development, China's international focus is beginning to change. After years of concentrating investment on sourcing energy and raw materials to feed its industrialisation, China is beginning to look at higher value added investments, with the acquisition of intellectual property becoming more evident in recent activity. In the short term, this provides the UK and Europe with the potential to access greater levels of capital to boost their growth prospects. In the longer term, however, it will become increasingly important to remain competitive as China looks to move higher up the value chain and into areas where more advanced economies currently hold their competitive advantage.

Economic update

The Chinese economy has begun to ease off the accelerator as it begins the process of rebalancing. Meanwhile the outlook for the UK and, to a lesser extent, the Eurozone, is strengthening.

After slower growth through the first half of 2013, China witnessed an increase in the pace of economic expansion in Q3, and is now expected to hit its growth target of 7.5% for 2013.

After three decades of break-neck paced growth, China appears to be experiencing a cyclical slowdown, exaggerating the deceleration in growth driven by the changing nature of its economy and demographics. The returns on investment have fallen, and the country is beginning to lose its competitive advantage in manufacturing as wages rise. China needs to find a new growth trajectory, based around domestic consumption rather than investment. While its population of 1.3bn people should provide plenty of scope for this, it will also be important to ensure that the policy environment is conducive to rebalancing the country's growth path.

In the UK, recovery has taken hold and growth in the short term shows little sign of slowing. The unemployment rate has fallen back to 7.4% – its lowest level for over four years – and inflation continues to ease and now stands at 2.1% on the consumer price index. Both business and consumer confidence rose sharply through 2013.

While growth was achieved across all broad sectors of the economy, alongside tentative signs business investment is starting to pick up, a lack of export growth remains a key missing link in the UK's recovery.

In the Eurozone, there has been less to cheer about. Despite technically exiting recession in the second quarter of 2013, a 0.4% contraction is expected for 2013 as a whole. A deficiency of demand is undermining growth prospects, reflected in the fall of annual consumer price inflation to just 0.9% in November 2013's data. In response to such news, the European Central Bank (ECB) moved to cut interest rates further, to just 0.25% in the same month. Economic growth of 0.7% is expected in 2014.

Table 1 - World, China, Eurozone and UK real GDP, annual percentage change

Year	World	China	Eurozone	UK
2001	1.6	8.3	2.0	2.2
2002	1.9	9.1	0.9	2.3
2003	2.8	10.0	0.7	3.9
2004	4.0	10.1	2.1	3.2
2005	3.6	11.3	1.8	3.2
2006	4.0	12.7	3.3	2.8
2007	3.9	14.2	3.0	3.4
2008	1.5	9.6	0.3	-0.8
2009	-2.1	9.2	-4.4	-5.2
2010	4.1	10.4	2.0	1.7
2011	2.9	9.3	1.6	1.1
2012	2.6	7.7	-0.6	0.3
2013	2.5	7.5	-0.4	1.9
2014	3.2	7.3	0.7	2.6
2015	3.4	7.0	1.1	2.0

Source: IMF, ONS, Macrobond

Trade between China and the UK and Europe

China has become an increasingly important trade partner to the UK and the EU over the past three decades. There is now evidence that UK and EU export shares are starting to grow more rapidly, with the UK taking greater advantage of the opportunity than the rest of the EU.

Over the past three decades bilateral trade between China and the UK and Europe has increased rapidly. In 1981 imports from China represented just 0.4% of the value total imported goods in both the UK and the wider EU. In 2012 this had increased to 7.1% in the UK and 6.4% for the wider EU. In 2012 this meant that the UK imported £39.2 billion in goods and services from China, while the EU as a whole imported £231.4 billion.

Over the same period, the UK and EU as a whole have increased their exports to China, though this has happened at a somewhat slower rate. In 1981, just 0.2% of UK goods exports, in value terms, were shipped to China, compared to 3.9% in 2012. Similarly in the EU the share of total exports going to China rose from 0.4% to 2.7% over the same period. In 2012 this was equivalent to £10.6 billion for the UK and £96.7 billion for the EU as a whole.

The growth in UK and EU exports to China has been less pronounced than the rise of imports from China. In part this reflects the mix of goods that the Chinese demand as the economy develops. Through the process of industrialisation, the focus was and indeed still largely remains on primary goods such as oil and minerals. As the population becomes wealthier, however, there is a growing demand for more luxurious items, such as cars, as well as more advanced industrial manufactured goods and, increasingly, intellectual property.

Trade between China and the UK and Europe

Table 2 - UK and EU Imports from and exports to China, percentage of respective total imports and exports

Year		1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Imports	UK	0.4	0.3	0.6	0.3	0.3	1.1	0.3	0.3	0.3	0.3	0.3
	EU	0.4	0.4	0.4	0.5	0.5	0.6	0.7	0.8	0.8	0.9	1.1
Exports	UK	0.2	0.3	0.6	0.5	0.7	0.9	0.7	0.6	0.7	0.7	0.5
	EU	0.4	0.4	0.5	0.5	0.9	0.9	0.7	0.7	0.6	0.5	0.5
Imports from China, % of exports to China	UK	176.4	118.5	107.3	64.8	47.4	141.4	59.1	73.4	59.5	48.0	77.3
	EU	120.3	112.6	97.4	85.2	56.0	67.0	94.4	110.6	130.9	175	230.7

Year		1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Imports	UK	0.4	0.9	1.1	1.1	1.1	1.3	1.5	1.5	1.9	2.1	2.4
	EU	1.3	1.6	1.7	1.7	1.8	2	2.1	2.2	2.6	2.8	3.2
Exports	UK	0.5	0.9	0.9	0.8	0.7	0.7	0.7	1.1	1.3	1.3	1.2
	EU	0.6	1.0	1.0	0.9	0.9	0.9	0.9	0.9	1	1.1	1.3
Imports from China, % of exports to China	UK	91	115.9	136.4	141.5	169.1	193.2	237.2	162.9	175.7	192.5	241.5
	EU	215.7	157.1	170.8	169.4	196	222.9	241.5	247.2	268.7	248.4	243.1

Year		2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Imports	UK	2.8	3.3	3.7	3.9	4.9	5.5	6.0	6.8	6.8	7.1	7.4
	EU	3.8	4.2	5	5.2	5.8	5.8	6.4	7.1	6.6	6.4	6.1
Exports	UK	1.2	1.4	1.4	1.4	1.8	2.0	2.2	2.9	3.1	3.9	3.4
	EU	1.5	1.6	1.6	1.7	1.8	1.9	2.5	2.6	2.7	2.7	2.8
Imports from China, % of exports to China	UK	303.1	315.1	344.4	371.1	406.7	377.3	397.4	343.1	303.3	275.3	260.6
	EU	249.1	263.7	321	306.1	323.9	314.1	259.2	284.1	252.3	239.4	215.3

Source: International Monetary Fund

China's impact on global commodity prices

The rapid industrialisation of China has acted to stoke the costs of energy and primary goods across the world. It's position as the consumer of 11% of the world's annual oil usage makes the outlook for the Chinese economy a key determinant of global energy, metals and other commodity prices.

In 1980, the Chinese economy was consuming 1.6 million barrels of oil on a daily basis, equivalent to 2.8% of global oil consumption. Through the process of industrialisation, this figure has rocketed to over 10 million barrels per day in 2012, or 11.4% of the world's oil usage with similar patterns across other commodities – China accounts for almost half of global steel consumption, for example.

Over the same time period the price oil has risen dramatically. From $34.0 in 1981, the global price of a barrel of oil has since climbed to an average of $103.9 over 2013, supported by demand from China, as well as other emerging markets. With Chinese growth expected to continue to slow over the coming decade, however, and new sources of supply also being accessed across the globe, pressure on commodity prices should begin to relax.

China's demand for agricultural produce is also having effects at the global level. The Chinese now account for 18% of the world's wheat consumption and 11% of beef and veal. Further growth in the Chinese population, expected to peak at over 1.45 billion in the 2030s, combined with increased wealth, will almost certainly drive up both total and per capita food consumption.

Demand for meat in particular is known to rise with incomes, and is increasing most quickly in fast-growing developing countries. Supporting this change in dietary preference requires relatively more grain than to support the rearing of livestock, in effect creating demand pressures throughout global food markets.

China's impact on global commodity prices

Table 3 - Chinese oil consumption, percentage of world total, and average price of Brent, Dubai and West Texas Intermediate, $US per barrel

Year	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
% of world consumption	2.8	2.7	2.8	2.8	2.9	3.1	3.2	3.3	3.4	3.6	3.5
Price	35.7	34	31.5	29.5	28.5	27.4	14.2	18.2	14.8	17.9	23

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
% of world consumption	3.8	4.0	4.5	4.5	4.8	5.2	5.6	5.7	5.9	6.2	6.3
Price	19.4	19	16.8	15.9	17.2	20.4	19.3	13.1	18.0	28.2	24.3

Year	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
% of world consumption	6.7	7.2	8.1	8.2	8.7	9.0	9.2	9.7	10.6	11.0	11.4
Price	25.0	28.9	37.8	53.4	64.3	71.1	97.0	61.8	79.0	104.0	105.0

Source: BP world energy review, Macrobond

Table 4 - China food consumption, percentage of world total

Year	Wheat	Beef and veal	Cow's milk	Rice
2008/09	16.4	10.2	7.0	30.4
2013/14	17.8	10.9	8.5	30.9

Source: US department of agriculture

The impact of Chinese savings

The impact of Chinese savings

Rapid economic growth and low levels of consumption in China have left a surplus of savings searching for investment opportunities. This has brought down borrowing costs in Western economies contributing to the 'hunt for yield' which preceded the 2007 financial crisis.

For the past three decades China has saved over 30% of its national income – the difference between what is produced and what is consumed by both individuals and government. In 1980, this flow of savings was equivalent to around 3.5% of global savings. Rapid industrialisation has not, as has often been predicted, brought down the Chinese savings ratio. In fact in 2012, gross national saving stood at 51.2% of GDP, almost 20 percentage points higher than in 1980. As a result, Chinese savings are expected to have accounted for 26.2% of global savings in 2013, with this proportion expected to rise still further.

This high level of saving has acted to push up the global savings ratio. And with more investable funds available, many interest rates have been driven lower. This is evidenced by the decline in many government bond yields over the period, as shown in table 6.

This reduction in the costs of borrowing and the returns on investment are undoubtedly a factor in driving the speculative investment which preceded the financial crisis. Chinese savings have reached such proportions that they now have a significant effect on other economies, including the UK and the rest of Europe.

Table 5 - Chinese gross savings, percentage of world savings and Chinese GDP

Year	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
% of world savings	3.5	3.8	4.0	4.0	3.7	3.1	3.1	3.4	3.6	2.9	2.9	3.2	4.3
% of Chinese GDP	32.2	35.5	35.6	35.5	34.6	35.9	37.1	37	36.3	39.2	39.4	38.8	42.5

Year	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
% of world savings	3.8	4.3	4.8	5.4	5.6	5.5	5.7	6.4	7.3	7.9	8.9	9.8	11.7
% of Chinese GDP	43.6	42.1	41.3	41.8	40.2	38.2	36.8	37.6	40.3	43.8	46.8	48	51.5

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
% of world savings	13.5	16.4	19.0	20.3	21.7	24.4	26.2	27.3	28.2	28.9	29.8	30.7
% of Chinese GDP	51.8	53.4	53.1	52.2	50.1	51.2	51.4	51.3	51.4	51.4	51.4	51.5

Source: IMF, Macrobond

Table 6 - Selected country 10 year bond yields

Year	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
UK	14.14	13.01	11.24	11.13	10.83	10.12	9.59	9.79	10.22	11.74	10.07
Germany	10.11	8.97	8.02	7.95	6.95	5.89	6.14	6.49	6.9	8.7	8.46
Italy	19.36	20.22	18.3	15.6	13.71	11.47	10.64	10.9	12.79	13.54	13.28
France	15.85	15.65	13.59	12.49	11.12	8.54	9.48	9.08	8.8	9.93	9.04

Year	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
UK	9.08	7.45	8.06	8.19	7.78	7.03	5.53	5.01	5.25	4.86	4.86
Germany	7.85	6.51	6.87	6.85	6.22	5.64	4.57	4.49	5.26	4.8	4.78
Italy	13.27	11.19	10.52	2.21	9.4	6.86	4.88	4.73	5.58	5.19	5.04
France	8.59	6.78	7.22	7.54	6.31	5.58	4.64	4.61	5.39	4.94	4.86

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
UK	4.47	4.86	4.4	4.49	5	4.5	3.66	3.59	3.03	1.88	2.34
Germany	4.07	4.04	3.35	3.76	4.22	3.98	3.22	2.74	2.61	1.50	1.54
Italy	4.25	4.26	3.56	4.05	4.49	4.68	4.31	4.04	5.42	5.49	4.35
France	4.13	4.1	3.41	3.8	4.3	4.23	3.65	3.12	3.32	2.54	2.18

Source: Eurostat, Macrobond

Future developments: Chinese investment and changing demands

Increasing outward investment, rising wealth and a shift towards consumption present both challenges and opportunities for the UK and Europe in the years ahead.

In just seven years, the flow of capital from China into other economies has increased dramatically, from $17 billion in 2005 to $60 billion in just the first half of 2013. Over the same time period, the focus of this outward investment has also started to change. Chinese investments are increasingly being directed more towards advanced economies in an effort to obtain intellectual property, where previously accessing commodities was the greater priority.

The UK is now the destination for 4.3% of Chinese investments, while the Eurozone accounts for 7.3%. For both economies, this improved access to capital is good news in the short term and should help to reinforce growth. In the long run, as China

looks to move higher up the value chain, advanced economies would do well to take steps to retain their competitiveness as far as possible.

Beyond investment patterns, rising wealth will also affect the nature of China's consumption. In one respect rising wealth should provide the UK and Europe with greater scope to expand their exports to China, as already seems to be happening.

But there are risks too, particularly to the world's ability to feed itself as China grows richer.

Since 1987, China's annual meat consumption per capita has almost trebled from 19.4 kgs to 57.3 kgs. Even with this dramatic rise, at its current meat consumption levels the average Chinese still consumes 50kg less meat each year than the typical American. Without substantial improvements in agricultural productivity, rising wealth in China has the potential to place immense strain on global food markets, ultimately resulting in higher food prices across the globe.

Future developments: Chinese investment and changing demands

Table 7 - Chinese meat consumption per capita, kgs

Year	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Chicken	1.4	1.8	1.83	2.1	2.64	2.97	3.75	5.08	6.35	7.33	6.01	6.56	6.93	7.4
Beef	0.7	0.81	0.9	0.96	1.13	1.47	1.84	2.53	3.34	2.82	3.49	3.78	3.98	4.02
Pork	16.62	18.02	18.63	19.71	20.9	22.32	23.89	26.52	29.97	25.65	28.9	30.98	31.74	31.19
Mutton and Goat	0.67	0.73	0.87	0.94	1.03	1.08	1.17	1.25	1.46	1.5	1.74	1.91	2.03	2.15

Year	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Chicken	7.23	7.43	7.7	7.64	7.71	7.89	8.64	9	9.15	9.29	9.66	10.01	10.24
Beef	3.95	4.05	4.19	4.28	4.29	4.33	4.59	4.58	4.31	4.17	4.10	4.13	4.21
Pork	31.59	31.9	32.56	33.07	34.49	35	32.32	35.15	36.57	38.14	37.11	38.95	39.89
Mutton and Goat	2.17	2.26	2.43	2.6	2.72	2.8	2.94	2.92	2.99	2.99	2.99	2.99	2.99

Source: Earth Policy Institute

Table 8 - Outward investment ($USbn), and destination (%)

Year	2005	2006	2007	2008	2009	2010	2011	2012	2013*
Total	17,170	35,350	46,390	82,220	83,360	118,450	116,410	129,020	59,740
% Eurozone		1.6%	2.1%	9.9%	1.2%	1.3%	5.5%	3.9%	7.3%
% UK		2.3%	6.6%	2.4%	2.0%	0.8%	0.4%	4.8%	4.3%

Source: The Heritage Foundation

** Data up to June 2013*

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