

# Research Paper

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## Brexit: Implications for EU–China Relations



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## Summary

- The extent of current UK relations with China means that Brexit will notably reduce the scale and diversity of overall EU–China economic and commercial interactions. But the impact will vary across different areas.
- In policy terms, liberal voices on economic policy towards China will be somewhat weaker among the post-Brexit EU27. Brexit will not be the most important factor determining the future level of strategic coherence in EU policy towards China.
- The impact on post-Brexit EU27 trade with China will be felt both in the volume of trade and its composition. Following Brexit the EU will no longer be China’s largest trading partner.
- There will be some relative shift in Chinese investment in Europe away from the UK, though over time the impact of Europe-wide policy approaches to Chinese investment will have more impact than Brexit per se.
- EU–China educational exchanges will be weakened after Brexit, but inbound Chinese tourism will be less affected by Brexit.
- By 2025, the EU will have compensated for Brexit’s impact in some areas, but much depends on the EU’s own trajectory over the next decade.
- For Beijing, the EU–China relationship will take priority over UK–China ties. Within the EU, China’s relative focus on Germany will be even more significant.

## Introduction

In an era of global uncertainty, the EU–China relationship remains of critical economic and commercial importance for both the EU and China, and the relationship is of much wider significance given their contribution to the global economy. Over the period to 2025 (the period covered by the project of which this paper forms a part), a significant factor in the development of EU–China relations will be the impact of the UK’s decision to leave the EU (hereafter ‘Brexit’). This process will take place in the context of wider global uncertainty. This paper examines the likely implications of Brexit for economic and commercial relations between the EU and China.

The paper first discusses Brexit and its implications to provide a framework for subsequent analysis. This is followed by an assessment of the UK’s role in EU policymaking and implementation towards China, including what Brexit might mean for the coherence of EU policy regarding China. This informs the discussion in the next section, which projects the likely scale of post-Brexit relations between the EU27 and China, based on analysis of the UK’s existing relative contribution to EU–China economic and commercial interactions. This is followed by some brief comments on the broader EU–China relationship and a conclusion, which looks forward to post-Brexit EU–China relations in 2025.

## Brexit and its implications

Projecting the impact of Brexit on EU–China relations is complicated by the substantial uncertainty around the likely nature and details of the UK’s departure from the EU. Following Prime Minister Theresa May’s speech on 17 January 2017, and subsequent commencement of withdrawal proceedings, the assumption in this paper is that the UK will not only withdraw from the EU but also from the single market by the end of March 2019, and that – although it remains unclear whether the UK will still be part of the EU Customs Union – it is likely to negotiate its own trade deals over time, including with China. This is akin to what has been described as a ‘hard’ or ‘clean’ rather than ‘soft’ Brexit.<sup>1</sup> By 2025 there are a number of further possibilities: the UK might either be looking to mitigate the impact of a hard Brexit by moving closer to the EU, or alternatively have moved further away from the EU. These trajectories will be affected by intervening variables such as the responses from EU institutions and member states and from other external actors, including China. Given wider global uncertainty, which could last for some years, it is far from clear what assumptions will hold.

The causes of Brexit also need to be considered in assessing its impact. Many explanations have been offered, from internal Conservative Party politics to public views of immigration, long-standing ambivalence in the UK about the EU project, or that Brexit reflects the coming to the fore of wider structural political-economy trends such as resistance to globalization. All of these underlying structural forces, as much as Brexit itself, could affect the development of the EU and

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<sup>1</sup> A hard Brexit could mean complete withdrawal from the EU, the UK trading on WTO rules and negotiating its own trade deals over time, restrictions on EU migrants mirroring those from elsewhere, and potential tariffs on imports from the EU. Under a soft Brexit the UK could remain in the European Economic Area and Customs Union, participate in research and development programmes, have more limited ability to negotiate its own trade agreements, enjoy tariff-free trade with the EU, with some elements of the ‘emergency brake’ on free movement of people. See Dickinson, S. and Cox, E. (2016), *Brexit North: Securing a united voice at the negotiating table*, IPPR North, p. 7, <http://www.ippr.org/publications/brexit-north> (accessed 2 Dec. 2016).

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therefore have an impact on EU–China relations.<sup>2</sup> Wider questions facing EU and UK policy approaches to China over the period to 2025 – from industrial policy and economic development to the security environment – will also have an impact, whatever the consequences of Brexit or the direction of the EU. And irrespective of Brexit, debate has been growing in Europe about how to deal with the challenges and opportunities brought by the ongoing increase in China’s global economic influence.

There are also wider implications of Brexit and the development of EU–China relations for China’s external economic and political diplomacy, including priorities such as the internationalization of the RMB and future outward flows of foreign direct investment. In addition, there are broader implications for global order, from questions such as the changing distribution of political and economic power and the nature of global security challenges to the functioning of international institutions. This paper weaves in some discussion of these issues, but a thorough evaluation is beyond its remit.

For the UK, post-Brexit challenges will include untangling national policy towards China from its joint policy with the EU, whether to continue broadly to align its China policy with that of the EU (on the basis that broad interests with respect to China are likely to converge still), the impact of relations with the US, or even whether to align more closely with China.<sup>3</sup>

## **Policymaking and positioning: the EU without the UK**

The UK’s role in the formulation of EU foreign and security policy has been a significant one,<sup>4</sup> including the aspects related to China. In terms of expertise, British officials have regularly taken China-related posts in EU institutions (for example in the EU mission in Beijing, and as desk officers in Brussels). The contribution of UK government officials to China-related discussions in EU institutions and between member states is also seen as important by many who have engaged in the EU’s China policy. British officials played a central role in the drafting of the paper setting out ‘Elements for a new EU strategy on China’, issued on 22 June 2016.<sup>5</sup> After Brexit, there is likely to be a transition period for EU policymakers during which there is a risk of reduced capacity in making China policy, though with time the impact of this will likely diminish.

The UK’s general policy towards China has been characterized in terms of relatively liberal approaches to economic and commercial issues, within a broader framework that emphasizes engagement with China while ensuring that promotion of values still plays a part. Discussions conducted for this research suggest that there is a perception among many EU policymakers and

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<sup>2</sup> Broad scenarios for the future of the EU27 range from a ‘status quo’ scenario, an ‘EU reform’ or strengthening scenario (such as a Eurozone-only EU, or a reformed EU with associate membership), or greater fragmentation within the EU27 leading to an unsustainable EU or reduced authority of EU institutions; the implications of this last scenario for EU–China relations would be either a reduction to a series of bilateral relationships with China and/or the management of Europe–China relations through a series of sub-regional European groupings. The base case in this paper is a status quo scenario. See Dickinson and Cox (2016), *Brexit North*, p. 6.

<sup>3</sup> For a brief discussion, see Summers, T. (2016), ‘Brexit and the UK’s China challenge’, Chatham House Expert Comment, 5 August 2016, <https://www.chathamhouse.org/expert/comment/brexit-and-uks-china-challenge> (accessed 2 Dec. 2016).

<sup>4</sup> Whitman, R. (2016), ‘Brexit or Bremain: what future for the UK’s European diplomatic strategy’, *International Affairs* 92(3): pp. 509–529; Chrysogelos, A. (2016), *European Foreign Policy and the EU’s Crisis of Governance*, Research Paper, London: Royal Institute of International Affairs, <https://www.chathamhouse.org/publication/eu-crisis-governance-and-european-foreign-policy> (accessed 2 Dec. 2016).

<sup>5</sup> Gaspers, J. (2016), ‘Brexit is bad news for European China policy’, MERICS blog, 12 July 2016, <https://blog.merics.org/en/blog-post/2016/07/12/brexit-is-bad-news-for-european-china-policy/> (accessed 2 Dec. 2016). For the strategy paper, see ‘Elements for a new EU strategy on China’, Joint communication to the European Parliament and the Council, Brussels: European Commission, 22 June 2016, [http://eeas.europa.eu/archives/docs/china/docs/joint\\_communication\\_to\\_the\\_european\\_parliament\\_and\\_the\\_council\\_-\\_elements\\_for\\_a\\_new\\_eu\\_strategy\\_on\\_china.pdf](http://eeas.europa.eu/archives/docs/china/docs/joint_communication_to_the_european_parliament_and_the_council_-_elements_for_a_new_eu_strategy_on_china.pdf) (accessed 2 Dec. 2016).

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opinion formers that this UK commitment to values was compromised somewhat from December 2013, under a policy of accommodation towards China led by then Prime Minister David Cameron and former Chancellor George Osborne. Although the post-Brexit government has signalled a slightly more guarded approach to China, it is likely to continue to seek better relations with Beijing given China's greater influence in global affairs and the growing potential for trade and investment with China. However, this does not necessarily make the UK an outlier among EU member states, which have long sought to balance commercial and other objectives in dealing with China.<sup>6</sup>

Given the UK's significant contribution to current EU policy on China, liberal voices on economic policy towards China will be somewhat weaker among the post-Brexit EU27. The EU could therefore take a more protectionist approach towards China, especially given rising protectionist pressure following growing Chinese industrial competitiveness and appetite for acquiring European corporate assets.<sup>7</sup> The broad EU approach of engagement with China will likely continue in line with the EU's 'Elements for a new EU strategy on China' document,<sup>8</sup> though as recent debates over market economy status and responses to the July 2016 ruling on the South China Sea have shown, there are different approaches towards China across the EU.

In this context, EU institutions have long emphasized a desire for a more joined-up and consistent China policy. This was an objective set out in the June 2016 strategy paper. Brexit raises the question of whether we will see a more coherent EU policy towards China. Put another way, has the UK been a force for a more united or divided EU policy towards China? The recent debate over granting market economy status (MES) to China demonstrates that there is plenty of division among other member states, but the UK – whose preference for granting MES put it at one end of the spectrum of member states' views – did not play a decisive role in the EU's final response to China's claims over MES in 2016. On other contentious issues, such as the South China Sea, the UK broadly agreed with the international consensus and London has also aligned itself with recent EU statements on human rights in China.<sup>9</sup> It has been suggested that the withdrawal of the UK might even upset the balance among member states, making the formulation of a coherent China policy more difficult,<sup>10</sup> or that a more 'mercantilist' UK approach to China might sow seeds of division among the EU27. However, although the question of coherence in EU policy towards China varies according to the issue, other factors are likely to be more significant than Brexit in determining the coherence of EU27 policy towards China.

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<sup>6</sup> Fabrizio, R. (2015), 'UK's strategic China-US balancing act', East Asia Forum, 11 November 2015, <http://www.eastasiaforum.org/2015/11/11/uks-strategic-china-us-balancing-act/> (accessed 2 Dec. 2016).

<sup>7</sup> See Hanemann, T. and Huotari, M. (2017), 'Record flows and growing imbalances: Chinese investment in Europe in 2016', MERICS papers on China, pp. 8–9, [https://www.merics.org/fileadmin/user\\_upload/downloads/MPOC/COFDI\\_2017/MPOC\\_03\\_Update\\_COFDI\\_Web.pdf](https://www.merics.org/fileadmin/user_upload/downloads/MPOC/COFDI_2017/MPOC_03_Update_COFDI_Web.pdf) (accessed 2 Feb. 2017).

<sup>8</sup> See footnote 5.

<sup>9</sup> For example, British Embassy Beijing, 'EU statement on the conviction of Chinese lawyers and other human rights defenders on charges of state subversion', 5 August 2016, <https://www.gov.uk/government/world-location-news/eu-statement-on-the-conviction-of-chinese-lawyers-and-other-human-rights-defenders-on-charges-of-state-subversion> (accessed 2 Dec. 2016).

<sup>10</sup> Chrystosgelos (2016), *European Foreign Policy*, p. 19.

## The UK's contribution to EU economic and commercial interactions with China

The UK has made a significant contribution to EU–China economic and commercial relations. To put this in context, the UK accounted for 17.5 per cent of the EU's GDP in 2015, while it had 12.7 per cent of the EU's population (since the Brexit vote the substantial decline in the value of sterling means that the UK's share of the EU economy has declined). Consideration of the UK's contribution to EU–China interactions also needs to take account of structural differences between the UK economy and the rest of the EU, for example, a larger contribution in the UK of financial and professional services and the role of the City of London. UK service sectors accounted for 79 per cent of value added as a percentage of GDP in 2014, compared to 74 per cent for the EU as a whole;<sup>11</sup> manufacturing value added in the UK in 2014 was \$272 billion, 10.5 per cent of the EU total of \$2.59 trillion.<sup>12</sup>

### Trade in goods

The relative weight of the UK's contribution to the EU28 trade in goods with mainland China over the last four years has been in the region of 13–14 per cent (the UK accounts for about 2 per cent of China's total trade), and therefore lower than the equivalent proportion that might be expected considering the contribution of the UK in the EU28 economy (see Table 1). This data also shows that the UK has a much larger share of EU imports from China (around 16 per cent) than its share of EU exports to China (around 9 per cent).<sup>13</sup> This relatively low share of EU exports to mainland China has prompted policy drives by successive British governments to increase the UK's exports to China, but given the UK's share of exports is just short of its share of EU manufacturing value added, the relative weight in trade in goods may simply reflect the economic structure of the UK economy.

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<sup>11</sup> World Bank data available at <http://data.worldbank.org/indicator/NV.SRV.TETC.ZS>.

<sup>12</sup> World Bank data available at <http://data.worldbank.org/indicator/NV.IND.MANF.CD>.

<sup>13</sup> These figures are for mainland China, not including Hong Kong and Macao.



**Table 1: EU28 and UK trade with mainland China**

	<b>2016</b>	<b>2015</b>	<b>2014</b>	<b>2013</b>
EU imports from China (US\$ bn)	339.0	335.9	370.9	337.0
UK imports from China (US\$ bn)	55.7	59.6	57.1	50.9
UK proportion of EU imports from China (%)	16.4	17.7	15.4	15.1
EU exports to China (US\$ bn)	208.0	208.9	244.2	220.0
UK exports to China (US\$ bn)	18.7	18.9	23.7	19.1
UK proportion of EU exports to China (%)	16.4	17.7	15.4	15.1
Total trade EU–China (US\$ bn)	547.0	544.8	615.1	557.0
Total trade UK–China (US\$ bn)	74.3	78.5	80.9	70.0
UK proportion of total EU–China trade (%)	13.6	14.4	13.1	12.6
EU trade deficit (US\$ bn)	131.1	127.0	126.6	117.0
UK trade deficit (US\$ bn)	37.0	40.6	33.4	32.0
UK proportion of total EU–China trade deficit (%)	28.3	32.0	26.4	27.2

Source: China Customs, from HKTDC website (<http://research.hktdc.com>).

The UK accounts for a slightly higher proportion of EU28 trade with the Hong Kong Special Administrative Region, and in particular exports to Hong Kong (see Table 2). It should be noted that over 98 per cent of Hong Kong’s exports are re-exports, and the vast majority of EU imports from Hong Kong originate in mainland China.

**Table 2: EU–China and UK trade with Hong Kong, 2016**

	<b>EU (US\$ bn)</b>	<b>UK (US\$ bn)</b>	<b>UK proportion of EU total (%)</b>
Imports from Hong Kong	42.4	6.4	15.2
Exports to Hong Kong	34.2	5.7	16.8
Total trade	76.6	12.2	15.9

Source: Hong Kong Census and Statistics Department, from HKTDC website.<sup>14</sup>

The data also shows that, depending on the year, the UK has accounted for something in the region of 30 per cent of the EU’s trade deficit with mainland China (see Table 1). For 2015, the EU’s deficit was 23.3 per cent of total EU–China trade, whereas without the UK this proportion would have been 18.5 per cent, closer to China’s overall surplus of around 15 per cent of total trade in goods. An

<sup>14</sup> Data originally in Hong Kong dollars converted to US dollars at US\$1=HK\$7.8.

immediate consequence of Brexit will therefore be to reduce the relative size of the EU's trade deficit with China, though differences in the structure of China's trade across EU countries should be taken into account, in particular the fact that Germany is the only EU country that has a significant trade surplus with China. But the EU's reduced trade deficit with China after Brexit may reduce one source of political pressure around EU–China trade relations.

Immediately after Brexit, EU27 trade with China will by definition be lower than that of the EU28. Subsequent trends will depend on a number of factors, including arrangements for UK–EU trade after Brexit. There may be some diversion of exports from the UK to the EU27, for example in sectors with cross-border supply chains, which will be constrained by the UK's withdrawal from the single market, and where assembly might therefore shift to EU27 countries. But given the relatively low scale of UK exports to China, the scale of the EU27's exports to China will be affected less than EU27 imports from China, which will be substantially lower than those of the EU28, given that the UK accounts for around one sixth of current imports by volume.

The political symbolism of a lower volume of EU trade with China is worth noting. The EU (as an economic bloc) is currently China's largest trading partner, its largest export market, and second largest source of imports. This is often cited as justification for the importance of the relationship, and explains the central role that trade plays in EU–China ties. But Brexit will hasten the end of the EU's status as China's largest trading partner, something already being challenged by faster growth in US–China trade and rapid growth in trade between China and ASEAN (both the US and ASEAN have better demographic trajectories and growth profiles than the EU). Earlier this decade, Chinese leaders agreed separate but identical trade targets of \$1 trillion by 2020 with both the EU and ASEAN. These targets now look ambitious as global trade has slowed. But by the time the UK leaves the EU in 2019, on current rates of growth China's imports from ASEAN will clearly have overtaken its imports from the EU27, and the difference in Chinese exports to the two blocs will be marginal, whereas China currently exports around one-third more to the EU28 than to ASEAN.<sup>15</sup> After Brexit, therefore, the EU is highly unlikely still to be China's largest trading partner.

This could lead to some symbolic decline in the strategic importance attached by Beijing to the EU27. It might be replaced with a policy emphasis on trade with Europe as a whole, which would still include the UK as well as other non-EU European countries, rather than on the EU. China has already focused attention in trade policy terms on European countries not in the EU, having reached a free trade agreement (FTA) with Switzerland, which came into force in 2014, and begun negotiations with Norway in 2008 (talks were paused in 2010 due to wider issues in the bilateral relationship but are set to resume in 2017). This partly reflects value in these relationships in their own right, but also the desire to use these FTAs to encourage the EU to enter negotiations with China (see below). It is also important to note that, when EU28 trade with China is disaggregated by country, only Germany, the Netherlands and the UK are among the top ten destination countries for Chinese exports, while Germany alone is one of the top ten exporting countries to China. The relative importance of Germany in EU–China trade will therefore grow further after Brexit.<sup>16</sup>

The EU–China trade picture will not just change in aggregate terms. As research by Bruegel has highlighted, the UK's exports to China have a much higher proportion of consumer goods than

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<sup>15</sup> Author's projections using data from China Customs, Hong Kong Trade Development Council website (<http://research.hktdc.com>).

<sup>16</sup> I am grateful to an anonymous peer reviewer for this observation (and the related point on Germany made in the conclusion, see below). For the 2016 data, see [http://info.hktdc.com/hktdc\\_offices/mi/ccs/index\\_static\\_type/Top10countriesn5MajorProductsexeng.htm](http://info.hktdc.com/hktdc_offices/mi/ccs/index_static_type/Top10countriesn5MajorProductsexeng.htm).



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those from the EU as a whole, with a broad-based set of consumer goods accounting for 45 per cent of UK exports to China but only 25 per cent of EU exports to China as a whole.<sup>17</sup> The UK currently accounts for about 16 per cent of total EU exports of consumer goods to China; as such exports of consumer goods will therefore account for a slightly lower proportion of EU–China trade immediately after Brexit (around 20 per cent). The growing challenge that domestically manufactured Chinese capital goods are posing to European exports in this area may constrain further growth in EU exports in this area.

One specific sector that requires further study is automotive, which has accounted for 35 per cent of UK exports to China, and where the UK accounted for 29 per cent of EU sectoral exports to China.<sup>18</sup> This is a particularly complex sector because of the cross-border nature of its supply chains, and it is one of the most vulnerable to the UK's withdrawal from the single market, acknowledged implicitly in the UK government's discussions in October 2016 with Nissan.<sup>19</sup> The prospects by 2025 for the automotive sector in the UK will therefore depend greatly on the nature of the post-Brexit UK–EU relationship, but the initial impact will be a substantially lower level of EU27 exports to China in this sector compared to the pre-Brexit EU figures.

### Service sectors

Trade in services between the EU and China remains at low levels, as does China's global trade in services. Within this, the UK plays a much stronger relative role than it does for trade in goods, being the second largest exporter of services globally after the US (\$341 billion compared to the US's \$690 billion), and well ahead of Germany and France (\$246 billion and \$239 billion, respectively).<sup>20</sup> As large parts of the Chinese economy are in transition from investment-led manufacturing to services, prior to Brexit the prospects for UK trade in services with China were generally seen as being better than trade in goods, with the possibility that faster growth in this area could make up for the UK's relatively poor performance to date in trade with China when compared to other major EU economies. The impact of Brexit on the UK's trade in services with China is likely to be indirect only, to the extent that Brexit has an impact on the development of service sectors in the UK more generally.

There will be more specific dynamics at play across financial services. The future of the City of London is one of the big post-Brexit questions and, put in the EU context, London's strengths as an international financial centre mean that the EU without London will be far less prominent. Other financial centres in Europe have a considerable gap to close with London in both depth and scale, though the response to Brexit from the financial services sector may offer them new opportunities. Early indications are that Chinese policymakers remain proactive in engaging with British counterparts on financial services cooperation, following the Brexit vote. But a lack of EU 'passporting rights' for London-based institutions could hamper China's financial services cooperation with both the UK and the EU.

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<sup>17</sup> Garcia-Herrero, A. and Xu, J. (2016), 'What consequences would a post-Brexit China-UK trade deal have for the UK?', Bruegel policy contribution 18, p. 6, <http://bruegel.org/2016/10/what-consequences-would-a-post-brexit-china-uk-trade-deal-have-for-the-eu/> (accessed 2 Dec. 2016).

<sup>18</sup> Garcia-Herrero and Xu (2016), 'What consequences?' pp. 6–7.

<sup>19</sup> Financial Times (2016), 'Theresa May's vow to pull Brexit "levers" won over Nissan', 27 October 2016, <https://www.ft.com/content/36e7f680-9c45-11e6-a6e4-8b8e77dd083a> (accessed 2 Dec. 2016).

<sup>20</sup> World Trade Organization data for 2015, via Hong Kong Trade Development Council website (<http://research.hktdc.com>).

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As far as China is concerned several specific areas related to financial services could be affected by Brexit:

- At the top of the list is RMB internationalization, after the Chinese government made London its centre for RMB clearing and settlement in 2014. As of 2015, the UK accounted for roughly two-thirds of the EU's RMB offshore business.<sup>21</sup> Even this does not amount to more than 7 per cent of total RMB offshore business globally, which is dominated by Hong Kong, but it has played an important strategic role in bringing Europe into the internationalization of the Chinese currency.
- Expansion plans by Chinese banks and financial institutions. With the UK in the EU, London was the obvious hub for Chinese banks moving into Europe. London will still remain an obvious choice for banks looking to develop business in the UK market (primarily commercial banking), but a UK withdrawal from the single market or divergence in regulation could reduce London's attractiveness as a base for European operations. Given that Chinese banking investment in Europe is so far at a very early stage, it would be easy for banks to shift strategies and use other European cities as their European headquarters (see discussion below of Chinese investment in Europe). By 2025 the footprint of Chinese commercial banks in Europe is likely to be stronger in the EU27.
- Overseas listings. Although London has been home to a number of Chinese listings, this has not developed into a strong trend and is unlikely to be impacted by Brexit.

## Investment

The UK's weighting of Chinese investment in Europe is in marked contrast to its trade contribution. Until the last couple of years the UK was the most popular destination for new Chinese investment in the EU, though it is important to note that the absolute stocks of Chinese investment in Europe remain low, even though investment flows have increased substantially since 2011.<sup>22</sup> Earlier research has found that France, Germany and the UK together accounted for an average of 51 per cent of annual Chinese investment (flows) from 2003 to 2011, based on Chinese statistics.<sup>23</sup> More recent analysis from the Mercator Institute for China Studies (MERICS) and the Rhodium Group implies that the UK accounted for some 23 per cent of total stock of Chinese foreign direct investment in the EU28 from 2000–16 (see Table 3). The immediate effect of Brexit will therefore be to reduce the total stock of Chinese FDI in the EU by over a fifth,<sup>24</sup> though in comparison to total FDI stocks the difference will be negligible. However, whereas changes in the structure of trade in goods will take some time to feed through, the investment picture is more dynamic. This is partly because of trends not related to Brexit, which mean that Chinese investment in Europe has been increasing rapidly from low levels across the continent over the last five years, mainly due to mergers and acquisitions, where Germany is now a more popular location than the UK.<sup>25</sup> Chinese investment flows into the UK in 2015 and 2016 were 16 per cent and 21 per cent, respectively, of

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<sup>21</sup> Data from SWIFT and Natixis, provided by Bruegel.

<sup>22</sup> The data is somewhat inconsistent (Chinese Ministry of Commerce data tends to report higher figures than Eurostat), and distorted by the use of 'pass-through' locations as investment gateways into the EU.

<sup>23</sup> Clegg, J. and Voss, H. (2014), 'Chinese overseas direct investment into the European Union', in Brown, K. (ed.) (2014), *China and the EU in context: insights for business and investors*, London: Palgrave Macmillan, p. 19.

<sup>24</sup> The precise proportion will depend on investment flows in 2017 and 2018.

<sup>25</sup> Clegg and Voss (2014), 'Chinese overseas direct investment', p. 23.

those into the EU28, and Germany attracted more foreign direct investment from China in 2016 than the UK.<sup>26</sup>

**Table 3: Chinese foreign direct investment in the EU28 and the UK**

Time period	EU total (EUR bn)	UK total (EUR bn)	UK proportion of EU total (%)
2000–14	46.1	12.2	26.5
2000–15	64.4	15.2	23.5
2000–16	101.1	23.6	23.4

Source: Mercator Institute for China Studies (MERICS).<sup>27</sup>

However, because Chinese investment in the UK and the EU is a relatively recent phenomenon, existing and potential Chinese investors do not face the same dilemmas as Japanese or some other major foreign investors, who have to deal with long-standing and substantial manufacturing operations often involving cross-border supply chains and management that were put in place on the assumption of UK membership of the single market.<sup>28</sup> The lack of existing investments in the UK would mean that many Chinese investors could easily choose the rest of the EU, though companies will need to take into account the risks of greater protectionism as the politics of Chinese investment in Europe has become more contentious. The fundamentals – desire to access brands, technology and markets – suggest that Chinese investment in Europe will continue to grow, though the big leap in flows recorded in 2016 may not be repeated due to regulatory tightening in China and policy concerns in the EU.<sup>29</sup>

There are conflicting views on the impact of the UK's withdrawal from the single market on Chinese investment flows. The government's marketing messages to potential Chinese investors have for over a decade consistently placed access to the single European market as a key selling point for investment in the UK. In advance of the referendum, prominent Chinese businessperson Wang Jianlin – founder of Dalian Wanda Group and a substantial investor in the UK – commented that Brexit would 'create more obstacles and challenges for investors' and that 'many Chinese companies would consider moving their European headquarters to other countries'.<sup>30</sup> After the referendum result, though, a number of Chinese commentators played down the impact, with influential economist David Daokui Li saying that most Chinese investments in the UK were either in property or mergers and acquisitions with high-tech UK companies, and that 'these two categories of

<sup>26</sup> Calculated from data in Hanemann, T. and Huotari, M. (2017), 'Record flows'.

<sup>27</sup> Author's calculations based on data for 2000–14, 2000–15 and 2000–16 sourced respectively from Hanemann, T. and Huotari, M. (2015), 'Chinese FDI in Europe and Germany: preparing for a new era of Chinese capital', MERICS and Rhodium Group, June 2015, <https://www.merics.org/en/merics-analysis/papers-on-china/cofdi/merics-analyses/> (accessed 2 Dec. 2016); Hanemann, T. and Huotari, M. (2016), 'A new record year for Chinese outbound investment in Europe', MERICS papers on China, February 2016, [http://www.merics.org/fileadmin/user\\_upload/downloads/COFDI\\_2016/A\\_New\\_Record\\_Year\\_for\\_Chinese\\_Outbound\\_Investment\\_in\\_Europe.pdf](http://www.merics.org/fileadmin/user_upload/downloads/COFDI_2016/A_New_Record_Year_for_Chinese_Outbound_Investment_in_Europe.pdf) (accessed 2 Dec. 2016); Hanemann, T. and Huotari, M. (2017), 'Record flows and growing imbalances: Chinese investment in Europe in 2016', MERICS papers on China, January 2017, [https://www.merics.org/fileadmin/user\\_upload/downloads/MPOC/COFDI\\_2017/MPOC\\_03\\_Update\\_COFDI\\_Web.pdf](https://www.merics.org/fileadmin/user_upload/downloads/MPOC/COFDI_2017/MPOC_03_Update_COFDI_Web.pdf) (accessed 2 Feb. 2017).

<sup>28</sup> Nilsson-Wright, J. and Fujiwara, K. (2016), *Brexit and its consequences: Anglo–Japanese relations in a post-EU referendum world*, Chatham House briefing paper, <https://www.chathamhouse.org/publication/brexit-and-its-consequences-anglo-japanese-relations-post-eu-referendum-world> (accessed 2 Dec. 2016).

<sup>29</sup> Hanemann, T. and Huotari, M. (2017), 'Record flows', p. 9.

<sup>30</sup> Quoted in Le Corre, P. (2016), 'Could Brexit bring the end of the new Sino-British "special relationship"?'', Brookings Institution, 17 March 2016, <https://www.brookings.edu/blog/order-from-chaos/2016/03/17/could-brexit-bring-the-end-of-the-new-sino-british-special-relationship/> (accessed 2 Feb. 2017).

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investment are meant to benefit local economic growth of the UK, so they would not be impacted by [Brexit].<sup>31</sup> In July 2016, the British government cited commitments from a number of leading Chinese companies to continue to invest in the UK, including that the Wanda Group was ‘looking for further UK land and property investments’.<sup>32</sup> These issues will nonetheless be interrelated, with prospects for land and property investments in the UK linked indirectly to the impact of Brexit on the British economy, in particular in London.

Other research suggests that the single market is a motivation for around half of Chinese investment deals in Europe, though in terms of volume this is a much smaller share of actual investment.<sup>33</sup> Rather than the issue of whether investors might use the UK as a base for trade with or selling into the rest of the single market, other post-Brexit policy decisions might have more of an impact, such as access to European talent or labour in the UK (for example, in research intensive businesses that rely on skilled labour from across Europe, or in retail sectors where much of the workforce has been migrants from other EU member states). Taken together, though, these factors suggest that – all things being equal – the UK leaving the single market will lead to a shift in the relative size of new Chinese investment away from the UK towards other EU countries, but that the scale and profile of this is difficult to judge at this stage, and will depend on factors beyond Brexit.

Assuming continued overall growth in Chinese outward investment flows, there would therefore not be a decline in the absolute levels of Chinese investment in the UK. In the short term, the fall in the value of sterling has made investment in property and corporate acquisitions in the UK some 15 per cent cheaper. Indeed, Chinese investment is more likely to grow in these areas than in the sort of greenfield manufacturing or assembly operations that were characteristic of an earlier phase of Japanese investment stimulated by a desire to access the European single market.

One related consideration will be any post-Brexit changes in the relative openness to foreign direct investment from China between the UK and EU27. It is generally considered that the UK has been more open to FDI and to Chinese investment than other major EU member states, though there has also been a trend among some other EU member states to welcome greater volumes of Chinese investment over recent years. Policy debates on these issues are ongoing both in the UK and across the EU. For the UK after Brexit, economic considerations may lead the government to seek as much inward investment as possible, but at the same time the current government has begun to develop an industrial strategy and there is talk of shifts in the foreign investment regime, which may give the government greater powers to intervene in particular cases.<sup>34</sup> The way Prime Minister May’s decision to review the Hinkley Point C nuclear power plant was presented in the summer of 2016 suggested that the new post-Brexit government might be less welcoming than its predecessor to future Chinese investment in critical infrastructure, although the deal was approved not long after.

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<sup>31</sup> Quoted in South China Morning Post (2016), ‘Brexit could put Chinese buying of UK assets on hold’, 27 June 2016, <http://www.scmp.com/business/money/markets-investing/article/1982223/brexit-could-put-chinese-buying-uk-assets-hold> (accessed 2 Feb. 2017).

<sup>32</sup> UK government website (2016), ‘Trade and Investment Minister works towards deeper trading relationship with Hong Kong and China’, 11 July 2016, <https://www.gov.uk/government/news/trade-and-investment-minister-works-towards-deeper-trading-relationship-with-hong-kong-and-china> (accessed 2 Feb. 2017).

<sup>33</sup> Discussions conducted as part of this research.

<sup>34</sup> See, for example, Covington (2016), ‘A new foreign investment regime in the UK’, 14 December 2016, <https://www.cov.com/en/news-and-insights/insights/2016/12/a-new-foreign-investment-regime-in-the-uk> (accessed 2 Jan. 2017).

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Within the EU there is a growing debate about whether some sort of EU-level screening mechanism should be put in place for certain foreign investments.<sup>35</sup> Divergence in policy approach between the UK and EU27 (either at EU or member state level) is therefore possible, though the positive approach to Chinese investment in parts of Europe will probably prevent the gap from becoming too significant. And even if there is some regulatory divergence, asymmetry in market size between the UK and the EU27 will mean that the UK is unlikely to increase substantially the size of its investment flows relative to the EU27.

The dynamics of EU investment in China are less likely to be affected by Brexit. The drivers here are more to do with the state of the Chinese market, the policy regime in China, and the role that China-based operations (including in research and development) play in the global strategies of multinationals with European bases. One factor, which could affect the statistics on UK investment in China, would be if multinationals currently based in the UK moved their headquarters out of the UK because of Brexit or used jurisdictions other than the UK for investment into China after Brexit.

### Trade and investment agreements

Brexit also has implications for the two major trade and investment agreements that could be reached between the EU and China. The status of these is different: a comprehensive agreement on investment (CAI) is currently being negotiated by the EU and China building on existing bilateral investment agreements (post-Lisbon Treaty the EU has taken on investment policy), whereas the EU's clear position on an FTA is that negotiations can only start once the CAI is concluded.

The UK's position on an FTA with China has been more positive than that of the EU institutions or other member states for some time, with then Prime Minister Cameron calling for negotiations on an EU–China agreement in December 2013 as UK–China ministerial contacts were resumed after an 18-month freeze, a statement that was 'not well received in Brussels'.<sup>36</sup> Voices from British business are already encouraging the UK to negotiate an FTA with China,<sup>37</sup> though delivering an agreement with significant liberalization and market access in services will be difficult, and the China market will remain challenging due to geographical distance, differences in business culture, and regulatory uncertainty.

However, as research by Bruegel has shown, the more favourable any FTA reached between the UK and China, the harder it will be for the UK to reach a good deal with the EU, to ensure that the UK cannot become a 'back door' for Chinese products to enter the EU.<sup>38</sup> Sequencing future agreements will therefore be important for the UK, first defining the baseline WTO arrangements, and then negotiating with the EU27 before concluding any agreement with China. Research by the China Center for International Economic Exchanges (CCIEE) shows that a UK–China FTA cannot make up for the negative impact of Brexit on the UK, but that such an FTA would lead to the transfer of part of UK–EU and EU–China trade to UK–China. From China's perspective, it would benefit much

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<sup>35</sup> For an example of the EU discussions, see European Political Strategy Centre (2016), 'Engaging China at a time of transition', [https://ec.europa.eu/epsc/file/strategic-note-16-engaging-china-time-transition\\_en](https://ec.europa.eu/epsc/file/strategic-note-16-engaging-china-time-transition_en) (accessed 2 Dec. 2016).

<sup>36</sup> Garcia-Herrero, A. and Xu, J. (2016), 'What consequences?', p. 2.

<sup>37</sup> See China Britain Business Council (2016), 'UK companies confident in post-Brexit trade with China', [http://www.cbcc.org/cbbc/media/cbbc\\_media/KnowledgeLibrary/Reports/CBBC-Survey-2016-\(English\).pdf?ext=.pdf](http://www.cbcc.org/cbbc/media/cbbc_media/KnowledgeLibrary/Reports/CBBC-Survey-2016-(English).pdf?ext=.pdf) (accessed 2 Dec. 2016).

<sup>38</sup> Garcia-Herrero, A. and Xu, J. (2016), 'What consequences?'

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more from an EU–China FTA than a UK–China deal, and an EU–China FTA could also compensate for the negative economic impact on the EU of Brexit.<sup>39</sup>

Given that the UK has been an outlier in calling for an early start to negotiations, Brexit will make the early commencement and conclusion of negotiations on an EU–China FTA less likely. The prospects for an agreement, however, will probably depend more on changes in wider attitudes towards FTAs and the facilitation of global trade than Brexit per se, and given the current political climate in continental Europe, the conclusion of an EU–China FTA by 2020 looks unlikely. However, CCIIE research has also suggested that investment negotiations could be expanded and possibly merge with talks on an FTA.<sup>40</sup>

It would seem that the UK’s withdrawal from the EU will have only a marginal effect on the investment agreement negotiations, which are complex because of the growing political sensitivity of investment issues, but also because they are building on 26 (25 not including the UK) individual bilateral investment treaties agreed previously by member states with China.<sup>41</sup> The UK’s bilateral investment treaty with China – unlikely to change in the short term – is somewhat unusual in that it can be used by any investor investing from the UK, without needing to be based in the UK,<sup>42</sup> facilitating the UK as a so-called ‘pass-through’ location for FDI.

In the context of post-Brexit trade and investment agreements, it is also worth noting that the British government has talked positively about the prospects for agreements with Hong Kong to remove any barriers to economic and commercial relations. Given the long-standing openness to trade of Hong Kong’s economy, these would likely focus on targeted regulatory alignment or mutual recognition in areas from financial services to professional qualifications.<sup>43</sup>

## The broader EU–China economic and commercial relationship

Other elements of the socio-economic relationship between the EU and China that will be affected by Brexit include indicators of people-to-people interactions between the EU and China.<sup>44</sup> On student exchanges, as of 2015, more than one-third of the roughly 300,000 Chinese students studying at tertiary level in the EU were in the UK,<sup>45</sup> and the decline in sterling is likely to make the UK more attractive to Chinese students over the next few years, assuming no tightening in policy or practice on the issuing of student visas. The UK is also a strong player in institutional exchanges. Of the European universities that have campuses in China, a significant number are from the UK. In Europe, as of December 2016, UK universities hosted 29 Confucius Institutes, 23 per cent of the EU

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<sup>39</sup> Zhang, Z. and Li, D. (2017), ‘Analysis on the influence of building the EU–China FTA’, paper prepared for roundtable on EU–China Economic Relations: Looking to 2025 at Chatham House, 9–10 February 2017.

<sup>40</sup> Hao, J. and Li, D. (2017), ‘Progress, difficulties and promotion strategies of the EU–China BIT negotiation’, paper prepared for roundtable on EU–China Economic Relations: Looking to 2025 at Chatham House, 9–10 February 2017.

<sup>41</sup> Croatia and Ireland have no BIT with China. Belgium and Luxembourg have a joint BIT with China.

<sup>42</sup> Dutson, S. and Batada, A. (2011), ‘The benefits of the UK–China bilateral investment treaty’, *China Business Law Journal* 2(3), 2011, p. 83.

<sup>43</sup> Speech delivered by International Trade Secretary Liam Fox to the British Chamber of Commerce in Hong Kong, 5 January 2017, <https://www.gov.uk/government/speeches/liam-foxs-speech-to-the-british-chambers-of-commerce-hong-kong> (accessed 2 Feb. 2017).

<sup>44</sup> The research and innovation dimensions of the relationship will be discussed in a separate forthcoming Chatham House paper.

<sup>45</sup> Consistent data is difficult to source. In 2015/2016, a total of 91,215 mainland Chinese and 16,745 Hong Kong students enrolled in higher education courses in the UK (<http://institutions.ukcisa.org.uk/Info-for-universities-colleges--schools/Policy-research--statistics/Research--statistics/International-students-in-UK-HE/>). The Chinese government reports that at the end of 2015, there were a total of 303,000 Chinese students studying in the EU ([http://english.gov.cn/state\\_council/ministries/2016/10/09/content\\_281475461954076.htm](http://english.gov.cn/state_council/ministries/2016/10/09/content_281475461954076.htm)), similar to the number studying in the United States.



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total of 128, and the UK was home to 108 of the EU's 172 Confucius Classrooms.<sup>46</sup> The EU will therefore find the scale of its educational relationship with China substantially reduced after Brexit.

When it comes to Chinese tourists and visitors to Europe, however, the EU's positioning will remain strong. Partly as a result of the Schengen visa regime, continental Europe is already well ahead of the UK in terms of the number of Chinese visitors it attracts, though the decline in sterling could make the UK relatively more attractive.

There are other aspects of EU–China relations with implications for economic and commercial ties that will be affected by Brexit. One of these is EU–China cooperation in security, which has been growing in recent years as the relationship has broadened from economic and commercial cooperation. There is a wider question as to whether Brexit will open up space for EU-wide traditional security cooperation to move to a new level.<sup>47</sup> If there is greater EU coherence in this area, then in theory deeper EU–China security cooperation could follow, though the policy challenges here are substantial, not least given US interests in EU approaches in this area. Military cooperation at the EU level is complemented by bilateral military-to-military contacts. These are primarily carried out by the UK and France, covering issues such as peacekeeping, counter-piracy, disaster response and training, all of which are features of the EU-level dialogue,<sup>48</sup> though German–Chinese bilateral defence-related dialogue has also been growing. There may be more scope for the further development of non-traditional security cooperation.<sup>49</sup>

Another area where EU policymaking will need to adjust after Brexit is on Hong Kong, where the UK's historical ties and post-1997 monitoring of developments in Hong Kong have effectively put it in the lead when it comes to EU policy on Hong Kong issues. Institutionally, the adjustment will not be too difficult, as the EU already produces an annual report on developments in Hong Kong, and the EU office and consulates of other member states in Hong Kong (especially Germany) follow developments closely.

These wider political and security issues feed back into the economic and commercial relationship for two reasons. First, the EU and China have consciously agreed to broaden their relationship from the economic and commercial to include more political and security interactions, and second, there is a growing linkage between security and economic issues, particularly given the major economic and social security challenges facing the EU.

## Conclusion: the Brexit effect to 2025

To the extent that Brexit is part of a wider phenomenon of global flux, including changing approaches to globalization and regional integration, it will only be one factor in the development of EU–China relations, which will depend on China's strategic approach to the EU and the EU's own trajectory over the next decade.

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<sup>46</sup> Data collected from the official website of the official Chinese organization responsible for Confucius Institutes, [www.hanban.org](http://www.hanban.org) (accessed 7 Dec. 2016).

<sup>47</sup> Biscop, S. (2016), 'All or nothing? European and British strategic autonomy after the Brexit', Egmont paper 87, [http://www.egmontinstitute.be/wp-content/uploads/2016/09/egmont-papers-87\\_v1final.pdf](http://www.egmontinstitute.be/wp-content/uploads/2016/09/egmont-papers-87_v1final.pdf) (accessed 2 Dec. 2016).

<sup>48</sup> Duke, S. and Wong, R. (2016), 'Chinese and EU views of military security: crafting cooperation', in Kirchner, E., Christiansen, T. and Dorussen, H. (eds) (2016), *Security relations between China and the European Union*, Cambridge: Cambridge University Press, p. 35.

<sup>49</sup> There is much more to be said on the security issues, especially given changes in US approaches, but given the economic focus of this paper, further comment will be left to future research.

In China's eyes, the scale of the UK's interactions with China means that relative standing of the EU – and with it its status as a 'major power' in the current Chinese diplomatic approach – is likely to diminish, compensated for by more of a focus on wider Europe or individual member states (among which Germany would become even more prominent). The impact will, however, vary across issues. The EU27 as a trade and investment partner for China will be weaker after Brexit, and the impact on EU–China engagement in investment, finance and education will be substantial. There will be some relative shift in Chinese investment in Europe away from the UK, though by 2025 the impact of Europe-wide economic development and policy approaches to Chinese investment will have more impact than Brexit per se. In policy terms, liberal voices on economic policy towards China will be somewhat weaker among the post-Brexit EU27. Factors other than Brexit will be more important in the future level of strategic coherence in EU policy towards China.

By 2025, how might EU–China relations be different because of Brexit? This of course depends on the sort of Brexit deal agreed, and the subsequent approaches from the UK, EU and China. A softer Brexit, or one where the UK continues broadly to align its China policy with that of the EU, would provide a more stable set of relationships, and allow the UK, EU and China to take advantage of closer and smoother interactions between the UK and EU in the development of those relationships. A harder Brexit – which currently looks likely – will make this more difficult, creating new challenges for EU–China relations particularly in areas where the UK is stronger than the rest of the EU, such as financial services. Divergent policy approaches in areas such as the regulation of investment or trade agreements could also create frictions between the EU and UK in dealing with China, and offer China the option of leverage, which would strengthen its hand in negotiations with both the EU and the UK – though attempting to use this leverage could also damage China's relations with the EU (and the UK).

Finally, the space for innovations in UK–China trade and investment relations provided by Brexit will be complex for the UK to manage, and advantages for the UK may prove illusory. From a Chinese perspective, this opens up the possibility of using the UK as a test case for engagement with developed economies, or even as leverage in relations with the EU. But EU–China ties will always take precedence over UK–China ties from Beijing's perspective, given their greater scale and broader significance.

## About the author

Tim Summers is a senior consulting fellow for the Asia programme at Chatham House and teaches at the Centre for China Studies, the Chinese University of Hong Kong (CUHK). His research papers for Chatham House include *China's Global Personality* (2014), *The Asia-Pacific Power Balance: Beyond the US–China Narrative* (2015, with Xenia Wickett and John Nilsson-Wright), and a chapter on Hong Kong in *The Critical Transition: China's Priorities for 2021* (2017). Other recent publications include articles on China's belt and road initiative, or 'new silk roads' (*Third World Quarterly*), China's maritime disputes (*China Information*), British policy on Hong Kong (*Issues and Studies*), and his first book, *Yunnan – A Chinese Bridgehead to Asia* (Chandos, 2013). He was previously a British diplomat for 13 years, culminating in a posting as consul-general in Chongqing, southwest China, from 2004 to 2007. He holds a PhD in Chinese studies from CUHK, and is based in Hong Kong.

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