Understanding UK Strategic Dependence on Chinese Investment: The Case for ‘Partial Decoupling’

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Introduction

This report investigates the scale of Chinese investment in the UK economy. It argues that over-reliance on Chinese investment poses a threat to British interests – and looks at how the British Government should address that threat. Care must be taken to ensure a myopic focus on the pursuit of short-term economic gains does not expose the country to excessive dependence on China, thereby hindering the UK’s longer-term strategic interests. In an increasingly unpredictable world and faced with the rapid rise of China to pre-eminence on the world stage, it is vital that post-Brexit Britain is resilient, dynamic, and able to stand on its own two feet.

Recent events have led to an increasing global focus on the Chinese Communist Party’s (CCP) questionable domestic record. According to some reports it has interned up to a million Uyghur Muslims in ‘political education’ camps⁠¹ and imposed draconian ‘Security Laws’ on democratic protestors in Hong Kong.⁠² Independent trade unions are banned in China, and attempts to organise them have led to arrest.⁠³ At the beginning of the pandemic the CCP denied the existence of Covid-19 and silenced whistle-blowers.⁠⁴ It has, at times, refused to engage with the World Health Organisation or allow foreign journalists to investigate the cause of the virus.⁠⁵ After Britain offered citizenship to Hong Kong residents, the CCP warned the UK Government to ‘immediately correct its mistakes’.⁠⁶ Political figures and commentators such as Benedict Rogers⁠⁷ and Tom Tugendhat⁠⁸, as well as British academic Andreas Fulda⁹, have also expressed concerns relating to the CCP.

The pandemic has led to a heightened global sense that the CCP has become a problem for international relations. The western approach to China has in recent years been built on a misguided belief that globalisation, economic liberalism, and international organisations, abstract from nation-states, would be capable of ‘charming’ the CCP towards a more democratic and humanistic political regime. This has not proven to be the case.

President George H.W. Bush’s conversation with Chinese leader Zhu Rongji in 1998 is a famous example of this outdated conciliatory approach in practice. Bush asked Zhu how China’s privatisation programme was proceeding. Zhu responded that China was not undergoing privatisation, merely corporatising its large assets and ‘realizing state ownership’. With a nudge and a wink, Bush is reported to have replied that no matter how the Premier described the process, ‘we know what’s going on’.¹⁰

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¹ ‘Countries Blast China at UN Over Xinjiang Abuses’, https://www.hrw.org/news/2019/10/30/countries-blast-china-un-over-xinjiang-abuses
² ‘Hong Kong ’seeking arrest’ of fleeing activists’, https://www.bbc.co.uk/news/world-asia-china-53616583
³ ‘Two Chinese trade union officials arrested after helping workers: source’, https://www.reuters.com/article/us-china-labour-idUSKCN1NZ0SP
⁵ ‘Coronavirus: Why have two reporters in Wuhan disappeared?’, https://www.bbc.co.uk/news/world-asia-china-51486106
⁶ ‘China warns UK not to offer citizenship to Hong Kong residents’, https://www.bbc.co.uk/news/world-asia-china-54655285
⁷ ‘UK ’concerned’ as Hong Kong denies Benedict Rogers entry’, https://www.bbc.co.uk/news/uk-politics-41586529
⁸ ‘China fury: Row erupts as MP claims anonymous letters are bid by Beijing to threaten him’, https://www.express.co.uk/news/uk/1329342/china-news-fury-conservative-mp-tom-tugendhat-Hong-Kong-Beijing-Huawei
⁹ ‘Our universities have sacrificed academic liberty for Chinese cash’, https://www.thetimes.co.uk/article/our-universities-have-sacrificed-academic-liberty-for-chinese-cash-hiltlh8395
In 2019, former US Security Adviser John Bolton lamented this approach to the CCP, claiming that its acceptance into international frameworks has done more harm than good for America’s standing in the world. For many years, Bolton said, ‘American policy was based on the assumption that bringing China into the WTO would increase pressure to conform to international norms in trade and business areas. That has obviously not happened.’

This belief that free-markets and open trade with the CCP could transform the regime into a more democratic and liberal one was shared by former UK Governments. David Cameron and George Osborne both embraced the prospect of a warm relationship with China, claiming in 2015 that Britain’s relations with China had entered a ‘Golden Era’. In a joint press conference with President Xi Jinping at Downing Street, David Cameron was asked by a journalist in 2015 if it was possible to reconcile Chinese investment in the UK with the CCP’s domestic record. He responded:

‘My argument, and my contention after 5 years of doing this job, is that you can have both. Indeed, you must have both. The stronger our economic trading, business and other partnerships, the stronger our relationship and the more able we are to have the necessary and frank discussions about other issues. And it’s those discussions and that relationship that leads to that greater understanding that makes that positive.’

It is now evident that this outlook allowed many countries to be blindsided by the rise of China and, if anything, has made matters worse. The challenge from China, in which there is no explicit difference between business investment and the state is reflected in the role of the CCP. The Chinese Communist party has a membership of 90 million people and even where we consider the nature of business decisions, many of those private actors that are regarded as sitting in the private sector, the CCP still makes important decisions.

The nature of the Chinese Economy: The need for a recalibration of Britain’s response

The Chinese economy has grown enormously in recent decades. In 1978, it accounted for less than 1% of global trade. By 2000, this figure had increased to 3%. A decade later, its share had more than tripled, making China the world’s top exporter. It is widely accepted that the Chinese economy today ranks as the second largest in the world.

President Xi Jinping has said he wants China to be a ‘master of its own technologies’. Early reports suggest that its fourteenth Five-Year Plan for the economy for 2021 aims to achieve greater technological self-reliance and a stronger military to protect its economic and political interests.

China has more than 150,000 state-owned enterprises (SOEs) – of which up to 91 of its SOEs are on the Fortune Global 500 list. The CCP plays an active role in the management of SOEs, which are controlled by a single-government agency known as the State-owned Assets Supervision and

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13 Stephen Kinnock MP, Public Bill Committee, 1 December 2020, National Security and Investment Bill
Administration Commission of the State Council (SASAC).\textsuperscript{17} The SASAC has the power to hire and fire the management of SOEs, and operational autonomy is granted when the ambitions of the CCP are fulfilled. The SASAC has control of some of the largest corporations in the world. Moreover, as Charles Parton OBE, Senior Associate Fellow at the Royal United Services Institute recently informed MPs during committee proceedings, ‘Let us not forget that most foreign investment by the Chinese is state owned, so it is not just a fair bet but a fair certainty that any state-owned enterprise investing is fully politically controlled.’\textsuperscript{18}

SOEs are financed by state owned banks (SOBs) when the objectives of the SOE align with the state.\textsuperscript{19} SOBs play a crucial role in the success of SOEs as they provide rewarding financial instruments, such as subsidies, even when these businesses are operating at a loss. Extensive subsidies for SOEs are crucial to their success. According to the \textit{China Statistical Yearbook}, between 2005 and 2015 the CCP spent about 1\% of its GDP on R&D subsidies.\textsuperscript{20} The result of these subsidies is that China now dominates many areas of manufacturing in the world economy. For example:

\begin{itemize}
\item Haley and Haley (2013) wrote in the \textit{Harvard Business Review} that Chinese-manufactured products regularly sell for 25\% to 30\% less than those from the US or European Union.\textsuperscript{21} In 2000, China was a net importer of steel – with 13\% of world imports and 16\% of global output. By 2007, it had become the world’s largest producer, consumer, and exporter of steel. The \textit{Harvard Business Review} study also reported that during this period energy subsidies to Chinese steel totalled $27 billion.\textsuperscript{22}
\item In 2000, China possessed 5\% of the market share in solar cells. The CCP put tens of billions of dollars into production subsidies and, as a result, now controls 60\% of the market, effectively decimating the market for international competitors.\textsuperscript{23}
\end{itemize}

The UK was the second largest recipient of Chinese foreign direct investment (FDI) in Europe by volume in 2019, mostly due to Chinese-enterprise acquisitions of additional stakes in a data firm worth £1.8 billion. It also topped the list of European countries for the number of single transactions involving Chinese entities.\textsuperscript{24} Since 2000, the UK is reported to have attracted the most Chinese FDI in the EU by far, with a cumulative volume of €50.3 billion over that period, compared to €22.7 billion for Germany, the second-ranked country.\textsuperscript{25}

Despite the scale of investment into the UK, the nature of that investment is not heavily scrutinised by British public authorities. Issues such as whether such investment should be considered productive for the UK economy, or whether it adheres to global commitments to competition when, for example, those investments flow from state- or mixed-ownership enterprises with publicly recognised links to

\textsuperscript{17} Mark Wu, \textit{The ‘China Inc.’ Challenge to Global Trade Governance} (2016). Available at: \url{https://harvardilj.org/wp-content/uploads/sites/15/HLI210_crop.pdf} \\
\textsuperscript{18} Charles Parton OBE, Public Bill Committee, 24 November 2020, National Security and Investment Bill \\
\textsuperscript{20} ‘Corruption, Government Subsidies, and Innovation: Evidence from China’, \url{https://www.hbs.edu/faculty/Publication%20Files/19-031_e00c9459-f8a5-462b-8527-60f816aefe4c.pdf} \\
\textsuperscript{21} ‘How Chinese Subsidies Changed the World’, \url{https://hbr.org/2013/04/how-chinese-subsidies-changed} \\
\textsuperscript{22} ‘How Chinese Subsidies Changed the World’, \url{https://hbr.org/2013/04/how-chinese-subsidies-changed} \\
\textsuperscript{23} Rob Atkinson – China Research Group, ‘Innovation mercantilism: How China’s trade policies affect the West’, \url{https://www.youtube.com/watch?v=dwUbhClnrI} \\
the CCP – the sole ruling political party in the People’s Republic of China (PRC) – are not rigorously analysed.

Western governments can modify the extent to which their economies are influenced by ‘artificial’ advantages, such as subsidies in the form of tax reliefs. These are usually specific and proportionate, in comparison to the CCP’s use of subsidies for SOEs. A domestic problem lies therein: Britain may consider offering small cash grants to students or allowances to small business in order to promote emerging industries in the UK without tinkering too far with the principles of the free market. But if an SOE is funded directly by subsidies from an authoritarian regime with unlimited funds, then the artificial advantage accrued by a British company is outweighed. In effect, we arrive at a situation in which British small and medium sized enterprises – which make up most of the high-tech sector – are left vastly uncompetitive against SOEs.

The principles of the free market and fair competition are not being adhered to by China – this poses a significant long-term risk to British economic interests. The scale of Chinese investment in the UK is a problem. But to do anything about this will require a new approach involving intervention in instances where British national interests have not so far been adequately protected.

The Brexit referendum was, in part, a vote for the UK Government to ‘take back control’ of domestic affairs. Since it has left the EU with a trade deal, it follows the UK will have the opportunity to forge its own path without interference from other nations or political bodies. In this context it will be vital that British political leaders ensure the UK’s domestic interests are protected.

Covid-19 has highlighted the underlying flaws of the UK economy. It is a source of national embarrassment that the Government was required to purchase personal protective equipment (PPE) from Chinese state-backed companies to resolve shortages during the pandemic.26 Regardless of who supplies these materials, it is cause for concern that during a period of crisis the UK economy was unable to innovate and create what was necessary. The sense of disorientation is compounded by the pandemic and several of the complex challenges faced by the business environment in the recovery stage. They will undoubtedly become more vulnerable to hostile foreign takeovers, including by SOEs and state-influenced investment corporations. A fragile post-Covid economic revival – with businesses continuing to have poor access to loans or other borrowing instruments – will be hugely susceptible to hostile foreign takeovers from China and elsewhere.27 The UK economy must be recalibrated so that in the future it is less dependent on nations that are unpredictable and authoritarian.

Major Chinese investment into the UK: A research assessment

Our research found that eighty per cent of Chinese investment in the UK over the past decade (2009-2019) came from state-owned or Chinese Communist Party-linked corporations. This throws the need for a trade policy that restores the UK’s economic independence into sharp relief. We compiled data on Chinese state-owned enterprises and reported CCP affiliations, and coupled this with original investment data from the American Enterprise Institute (AEI) China Global Investment Tracker (CGIT)

27 Stephen Kinnock MP, Public Bill Committee, 26 November 2020, National Security and Investment Bill
– the only comprehensive worldwide public data set covering China’s global investment and construction contracts – to provide an account of Chinese investment into the UK.28

By analysing the 112 Chinese investments into the UK – including construction contracts – over the decade between 2009 and 2019, our research found that:

- Eighty per cent (90 of 112) of Chinese investments in the UK over this period involved either Chinese state-owned, mixed ownership or CCP-linked enterprises.
- £61.7bn ($80.4bn) of Chinese deals were struck over the 10-year period.29
- Of those £61.7bn ($80.4bn) of Chinese deals, the majority of investment – approximately £42bn (or 68%) – was completed during a period hailed as the Cameron-Osborne ‘Golden Era’ (2015-2019), with investment between 2009-201530 amounting to £19.7bn.
- Of the 12 deals worth over £1bn ($1.3bn) in today’s currency, three quarters (9) included state-owned entities and a clear majority (10) received investment from reported direct CCP-linked companies, connected by leadership in the Chinese entity (e.g., board members related to part of the CCP or internal CCP committees).
- Of the 40 Real Estate investments worth £11.6bn (or $15.2bn), 72% (29) were by state-owned (or mixed) entities and 22 (55%) were through directly CCP-linked companies – a further 10% having an informal CCP connection through alleged shared or cultural networks.
- Of the 8 Banking/finance investments worth £11.9bn (or $15.6bn), 75% (or 6 out of 8) were by state-or mixed-owned companies and were all through allegedly direct CCP-linked companies (through direct connections of leadership and/or officials).
- Of the 12 Energy investments worth £5.2bn ($6.9bn), 11 (over 90%) were by state-owned enterprises and half (6) were by CCP-linked companies.
- Of the 5 Technology investments worth £4.96bn ($6.48bn), 80% (or 4) were by state- or mixed-owned enterprises and all had some direct or informal CCP-link.
- Of the 10 Entertainment investments worth £2.7bn ($3.6bn), 40% (4) were by state- or mixed-owned enterprises and half (5) were made through CCP-linked companies.
- Where 30 Chinese entities took a 100% ownership in the UK business, 36% (11) were state-or mixed-owned and 60% (18) were through reported CCP-linked companies.
- Where 49 of the Chinese entities took a 49% stake or more in the UK business, over half (26) were state-or mixed-owned entities and just under 60% (29) were via reported CCP-linked entities.

The magnitude of those findings resonates with other research by the Henry Jackson Society that since 2010, some 115 British companies have been wholly or partly acquired by Chinese businesses.31 It is worth bearing in mind in this study that the China Global Investment Tracker (CGIT) contains only investment and construction transactions worth $95 million or more. It excludes bond purchases, loans, and trade deals.32 The CGIT itself is reliant on corporate sources, usually the Chinese

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28 We are grateful to Derek Scissors at the American Enterprise Institute (AEI) and also the Heritage Foundation for the China Global Investment Tracker (CGIT) – the only comprehensive worldwide public data set covering China’s global investment and construction contracts – which has been utilised to provide an account of Chinese investment into the UK: https://www.aei.org/china-global-investment-tracker/
29 All calculations made on midday exchange rate on 15 Oct 2020: 1 USD = 0.766745 GBP
30 Up to September 2015.
participants, but also foreign partners where available. The Civitas-collated data on state ownership and CCP-affiliations of companies is drawn from publicly available company disclosures, published independent investigations, the global financial press and Chinese financial news reports.

Pursuing ‘partial decoupling’ from China

Given the role of Chinese state-owned, mixed ownership or CCP-linked enterprises, the UK should pursue a ‘partial decoupling’ of its economic relationship with China. The idea of ‘partial decoupling’ has already been suggested by leading economic experts in the United States. Derek Scissors at the AEI has produced a series of research publications focused on the relationship between the United States and China. His work looks at how the United States can decouple from China and the reasons for, as well as the costs and benefits of, decoupling. It provides helpful insights in the British context.

Scissors (2020) describes decoupling as ‘a recognition that America should drop the pretence of changing the PRC, instead restricting and shrinking the economic relationship for an indefinite period because parts of it are harmful.’ He sees ‘Beijing’s commitment to the state sector’ as a central reason to do so. AEI research suggests that this commitment to supporting state-owned enterprises (SOEs) is damaging as it limits competition, enables SOEs to get into large amounts of debt without consequences and results in economic relations with China becoming unbalanced to the detriment of the United States.

Decoupling can be achieved by targeting five different key areas:

- imports;
- exports;
- inbound investment;
- outbound investment; and
- supply chain movement.

AEI research identifies that ‘documenting the PRC’s many subsidies is the necessary first step and nearly costless’. The same approach could be adopted by the Department for International Trade (DiT) and the Competition and Markets Authority (CMA), even if this were to create short-term price rises and elicit a retaliation from China.

Partial decoupling has become a necessity. It is as much as about avoiding losses as generating benefits. Future UK decoupling legislation would insulate against the challenges posed by current economic dependence on China. As AEI research implies, reducing Chinese distortion of global economies, including the UK’s would allow for a fairer redistribution of economic activity across the globe.

Conclusion: Enhancing the UK foreign investment system

Many countries are now going through a significant political shift in the scrutiny and review of foreign investment. Numerous jurisdictions have introduced new laws or modified old rules designed to restrict foreign investment.

The Committee on Foreign Investment in the United States (CFIUS) is an inter-agency body comprised of nine Cabinet members, two ex officio members and other members as appointed by the President.

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They assist the President in reviewing the national security aspects of foreign direct investment in the US economy. A comparable institution does not exist in the UK.

CFIUS reviewed the acquisition of the LGBT social networking app ‘Grindr’ in 2019.\(^{35}\) It raised concerns related mainly to foreign access by a Chinese company to the personal information of US citizens. As a result of the Committee’s expressed concerns, the Chinese company reportedly decided to divest itself of Grindr.

The remit of CFIUS extend to the powers of majority ownership, dominant minority interest, board representation, contractual rights, and other arrangements to determine, direct, or decide important matters affecting a US business.\(^ {36}\) US sensitive sectors are reported to include:

- Critical technologies (certain export-controlled technologies);
- Critical infrastructure (specific communications, energy, transport, and financial infrastructure, plus certain strategic materials and industrial resources);
- Sensitive personal data of US citizens (such as generic data or other personally identifiable data including financial, health, security, or other qualitative factors).\(^ {37}\)

In the European context, since 2004 Germany has adopted a foreign investment control (FIC) screening system.\(^ {38}\) As with many other countries, in recent years the rules have been constantly amended to significantly extend the government’s rights. For example, in 2018 the German government vetoed the takeover of an engineering company (Leifeld) by a Chinese firm (Yantai) on the grounds of national security.\(^ {39}\) Leifeld specialised in manufacturing for Germany’s aerospace and nuclear industries. Yantai dropped its attempt to buy the company ahead of the veto by Germany.

By contrast, the UK has no separate FDI regime. By pursuing a partial decoupling, the Department for International Trade (DiT) could seek to extend its role in this respect. There had until recently been no specific rules for foreign investors and/or state-owned enterprises willing to invest in the UK. However, the UK Government has finally caught up on the international scene with a new National Security and Investment Bill (NSIB), published early in November 2020. The NSIB offers new powers to the Government in an attempt to square the circle of free trade and national security – ensuring the UK is not a ‘back door’ for malicious foreign investors while also maintaining its identity as a ‘global champion of free trade and an attractive place to invest’.

It is also relevant that, at the time of writing, the Competition and Markets Authority (CMA) is seeking to comply with a wider EU FDI Regulation to create a cooperation mechanism for the exchange of information in relation to Foreign Direct Investments (FDIs) that are likely to affect security or public order of the EU Member States.\(^ {40}\) Compliance with and deference to the EU in this regard should be heavily scrutinised since the overarching problem has been that the UK has had lacked a

\(^{38}\) ‘Germany’s foreign investment regime’, https://www.pinsentmasons.com/out-law/guides/germanys-foreign-investment-regime
\(^{39}\) ‘Chinese takeover of German firm Leifeld collapses’, https://www.bbc.co.uk/news/world-europe-45030537
comprehensive UK-specific system of foreign investment control when compared with other major Western powers.

In the meantime, NSIB, currently before parliament, grants the Business Secretary powers to impose ‘proportionate remedies on specific acquisitions of control or qualifying entities and assets’. This means that ‘notifiable acquisitions’ of certain companies in sensitive sectors will be required, by law, to notify the government minister of a transaction ex-ante. The prospective key sectors that relate to ‘national security’ are predominantly located in emerging technologies, such as artificial intelligence, autonomous robots, computer hardware, and space technologies. Parties involved in ‘notifiable acquisitions’ will be mandatorily required to make the minister aware of any such transaction that is about to take place, which will then set off a ‘trigger event’.

Trigger events are defined as a range of transactions which enable the minister to scrutinise investment. For example, a ‘trigger event’ would occur if ‘a person gains control of a qualifying entity if the person acquires a right or interest in the entity which increases to over 25%, 50% or 75%.’ Under these conditions, the minister can call in a transaction for review if there is a reasonable suspicion that such an investment or change in the company’s government would give rise to a national security risk. Non-compliance with statutory obligations may result in fines of up to 5% of worldwide turnover or £10 million (whichever is higher), and up to five years imprisonment.

The NSIB is a step in the right direction. It effectively addresses a series of concerns that have been raised in this report. By introducing a new ‘screening mechanism’ in line with other Western countries, the UK Government will be able to present Parliament with an annual report of investments that have taken place in the UK. The impact assessment of the Bill estimates that between 1,000 and 1,800 investments could be monitored each year. Parliament will therefore be able to scrutinise these developments, ensuring that issues of national security are subject to democratic oversight.

The NSIB also requires that malicious entities that may have a ‘dual’ military and civil purpose are monitored via a screening mechanism. The granting to the government of powers to block investments where such a transaction would concern national security is also a positive development. NSIB, one law firm noted, ‘clearly signals the end of the UKs lighter touch approach to foreign investment screening and brings the UK into line with its international peers’. 41

Despite this, the NSIB does not go far enough. Several of the concerns that have been raised in this report remain unaddressed. Debates so far have focussed on the issue of defining ‘national security’ or the extent to which the NSIB can really protect the UK’s national infrastructure. But the wider issue at stake is how far the law will ensure economic resilience in the future. The Bill misses the opportunity to recalibrate our economy so that investment of the future enhances our productive capacity.

In one debate on the parliamentary proceedings on the NSIB, Sir Iain Duncan Smith MP called out several acquisitions relevant to the UK’s recent economic history with China that would not come under the remit of the Bill. He referred to research from the Henry Jackson Society: having looked through the Bill, they found that only 23 of the 117 Chinese acquisitions over the last decade would have actually been caught. 42 The areas that are outside of this include pharmaceuticals. This report identifies several sectors which arguably would have fallen outside the UK’s newly proposed scrutiny of investment.

42 HC Deb, 17 November 2020, c220.
The NSIB will not wholly enable governments to learn from the past mistakes of failing to scrutinise foreign investment into the UK. When scrutinising foreign investment, the ‘ownership base of the acquirer’ should play a role. Fundamental to this research, if the acquirer is a state-owned enterprise or a state-backed investment vehicle, then that should essentially trigger a higher level and more robust screening process. After all, many other regimes distinguish between a private sector acquirer and a state-backed acquirer – so why not in the UK?

During the proceedings of the NSIB, Stephen Kinnock MP repeatedly identified the relevance of state-owned enterprises as acquirers in raising specific security challenges. When focusing on the risk associated with the ‘acquirer’ in the Bill, the MP noted that the statement of political intent refers to:

‘the National Security and Investment regime does not regard state-owned entities, sovereign wealth funds – or other entities affiliated with foreign states – as being inherently more likely to pose a national security risk.’

The issue at stake is that the closer an entity (Chinese or otherwise) is to a foreign government, the more likely it is to pose a risk to our national security. The Bill neither suggests a special regime for SOEs, while accepting the state-owned attribute should not be considered. The statement of policy intent suggests that state-ownership is not inherently more likely to pose a national security risk. That very point is in question and the evidence presented in this research suggests, to the contrary, that some eighty per cent of Chinese investments in the UK over the past decade involved either Chinese state-owned, mixed ownership or reported CCP-linked enterprises.

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44 Ibid.