To: David Lammy, UK Foreign Secretary
From: Ffion Ross, British Diplomat
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RE: Trade imbalances between the UK and China

Summary

As the UK's fifth-largest trading partner from Q3 2023 to Q2 2024 (Department for Business and Trade, 2024), maintaining a stable trade balance with China is critical. This foreign policy memo outlines three policies which if implemented could help reduce the persistent trade imbalance between the UK and China. The policy that we recommend prioritising is providing additional support for SME's. This will allow them greater access to trade globally and therefore should improve UK economic growth, reducing the trade imbalance.

Background

Trade imbalance between the UK and China has become more prominent over recent years, peaking at -£36.9 billion in 2021 and remaining consistently high at -£26.1 billion in 2023 (Department for Business and Trade, 2024). These figures quantify the issues associated with trade imbalances, such as reduced economic growth, an unstable economy, unemployment issues and unstable interest rates. China accounted for 5.1% of total UK trade in the 12 months to the end of Q2 2024, but with the UK in a current trade deficit of £23.7 billion with China, more needs to be done to reduce trade imbalances between the UK and China as this will benefit both countries and their economies. (Department for Business and Trade, 2024).

Reducing the trade imbalance is achievable and an intervention is crucial to help the UK boost their economy as well as reduce our current reliance on China. The Covid-19 pandemic in 2020 brought to light the UK's reliance on China and it could be argued that this is an over-reliance, and we should reduce this to help lessen national security concerns, improve the economy and help the UK hold a better position globally when it comes to addressing geopolitical issues (Harris, Neal and McConalogue, 2021).

Policy Options

There are 3 potential policies for the government to choose between to try to reduce the trade imbalance between the UK and China.

Pursuing a Free Trade Agreement:

The first potential recommendation is to negotiate a Free Trade Agreement (FTA) with China which reduces tariffs and the restrictions on UK businesses trying to trade with China. We have been able to create such policies since the UK left the EU in 2020, which has allowed us to have more independence over our trade policies (Matty, 2022).

An FTA would significantly increase access to the Chinese market for UK businesses allowing the UK to have substantial advantages when trading with China in comparison to the rest of the EU (Herrero, Xu and Garcia-Herrero, 2016). Additionally, the amount of foreign investment coming into the UK would increase as it would be cheaper to invest in UK businesses in comparison to other countries which would encourage economic growth within the UK.

However, it could impact the UK's trade relations with other countries, making it harder to trade with the EU which would negatively impact UK businesses. Disparities could also be created between smaller and larger firms due to the complexity of trading globally requiring lots of knowledge in order to enter the global market. This knowledge is often expensive so small businesses that cannot afford this will be left at a disadvantage.

Devaluing our currency

Another policy suggestion is to devalue the British pound in comparison to the Chinese yuan. This would encourage trade between the two countries as it would be cheaper for Chinese consumers to buy goods from the UK in comparison to other countries.

An attractive aspect of this policy is the resulting increased UK competitiveness, as the price of exports decreases, making products cheaper to buy in comparison to alternatives. Furthermore, foreign investment will increase due to a more favorable exchange rate for many countries, in addition to China. Both impacts encourage economic growth and will reduce the trade deficit between the UK and China.

However, devaluing the pound could result in increased inflation rates, due to the cost of imported goods rising. With inflation currently close to the 2% target, this increase would be unfavourable. Moreover, this may create an unstable exchange rate which can deter investors from purchasing assets within the UK, further reducing investment (Hayes, 2023).

Support for SME's

Support for small and medium sized enterprises (SME's) can improve the trade imbalance due to this policy encouraging SME's to be more competitive within the global market. It can be challenging for SME's to have the knowledge and expertise of how to be successful in the global market as this information can be inaccessible. The government can offer support by encouraging the use of digital platforms, facilitating partnerships between businesses and providing additional training and upskilling. Whilst SME's account for 99.9% of all UK businesses, they only generate 52.5% of UK turnover (Merchant Savvy, 2022). This demonstrates that by focusing on improving the presence of SME's within the global market, there is strong potential for UK economic growth.

This reduces the barriers to entry for SME's, encouraging both their own trade and global growth and that for the UK economy also. These actions strengthen global supply chains with more goods available on the market, creating competition and promoting economic growth (OECD, 2024).

However, this could be a costly scheme for the government to deploy as the level of support needed for SME's to be able to trade globally is quite high and often economies of scale restrict SME's to be able to compete with larger firms. This policy could increase the number of larger firms in the UK if SME's expand in size however scaling up a business in size has it's own challenges.

Policy Recommendations

Therefore, our principal policy recommendation to reduce the trade imbalance between the UK and China is to support SME's to allow them greater access to be able to trade in the global market. Providing this support could enable them to trade with a global reach and could help them grow their business providing more employment opportunities and helping economic growth which is beneficial to both the businesses themselves and the UK government. Whilst potentially costly, resources can be made suitable to a variety of businesses and there are large opportunities for growth due to the current turnover for UK SME's. This policy has few negative effects to the UK's rate of economic growth compared to other policy suggestions and if successful could boost the economy, create a more competitive UK within the global market and reduce the trade imbalance between the UK and China.

Sources

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