Brexit:

Can China Keep Calm and Carry On?

While British citizens ponder their country's fate following the momentous UK EU referendum result, China is left wondering about the implications of Brexit on its international trade relations, its overseas investment strategy and economic direction. Alicia Garcia Herrero, Chief Economist of Natixis Hong Kong & Asia Pacific, sheds some light on three potential post-Brexit scenarios and their medium-to-long term impacts on China

By **Jennifer Khoo**

"The people of the United Kingdom have spoken."

- President Obama following the Brexit vote

On June 23rd 2016, the United Kingdom voted to leave the European Union in an historic move that plunged the nation into unchartered territory, roiling financial markets and the dynamics of international relations globally. The value of the British pound plummeted to a level not seen since the 1985 financial crisis, as investors across the globe panic-sold shares in one collective move.

Britain's change of government leadership that hastily followed ignited much speculation about the future direction of the country, while also raising questions over the invoking of Article 50 of the Lisbon Treaty – a move which would begin the two-year countdown on Britain's negotiation of exit terms – something no member state has ever done before.

Meanwhile in Asia, ripples of panic had spread across the region's financial markets. By the end of the announcement day, Japan's Nikkei Index tumbled by 7.9 percent; Hong Kong's Hang Seng Index fell by nearly 3 percent; and the Chinese yuan (renminbi) fell to its lowest level in more than five years.

Aside from the initial frenzy which has since subsided, the immediate impact of Brexit on Asian financial markets has been relatively minor. What remains to be seen is the longer-term impact that Brexit will have on the region, in particular China – the UK's largest trading partner in Asia and its fourth largest trading partner globally.

Possible scenarios

The medium-to-long term economic effects of Brexit on China's economy will depend in part on the negotiated outcome of Article 50 talks when they take place. The talks will establish the terms of Britain's new relationship with the EU following its exit, which will help paint a clearer picture for China of how multilateral trade and business will be newly conducted.

But in truth, it is more a question of what will happen to the EU (China's biggest trading partner) post-Brexit rather than the UK, which will have a greater bearing on China's economic future, according to Alicia Garcia Herrero, Chief Economist of Natixis Hong Kong & Asia. With a combined economy 4.2 times larger than that of the UK, the European single market is certainly a matter of greater concern for China.

While it is impossible at this stage to form any conclusions about what will transpire given the current level and scale of uncertainty, Herrero proposes three potential scenarios arising from Brexit and explains how each could, in turn, affect China's economic development in the coming years. The scenarios are as follows: 1) business as usual without much change; 2) a more united EU without Britain; and 3) a fragmented EU after Brexit.

Scenario 1: Few changes

In the case of what global credit insurance company Euler Hermes calls a "soft leave scenario" in its *Brexit: What does it mean for Europe?* report, the UK will likely have negotiated some kind of free trade agreement (FTA) with the EU upon its exit, with terms not too dissimilar from its existing setup.

In line with that scenario, Herrero in her analysis of the long-term considerations for China (entitled *Assessing China's post-Brexit globalization strategy* for

What is Article 50?

Article 50 of the Lisbon treaty outlines how an EU member country might voluntarily leave the union.

It specifies that a leaver should notify the European council of its intention, negotiate a deal upon its withdrawal and establish legal grounds for a future relationship with the EU. On the European side, the agreement needs a qualified majority of member states and consent of the European parliament.

The only real quantifiable detail in the article is a provision that gives negotiators two years from the date that Article 50 is invoked to conclude new arrangements. Failure to do so results in the exiting state falling out of the EU with no new provisions in place, unless every one of the remaining EU states agrees to extend the negotiations.

No country has ever invoked article 50 – yet.

Definition provided by The Guardian

European think tank Bruegel) points out that Chinese overseas direct investment in the UK is an area where Brexit will likely have great impact.

The scale of Chinese FDI in the UK has been quite large in recent years. Between 2010 and 2015, the amount of Chinese investment in the country reached EUR15.16 billion (US$17 billion), making Britain the number one EU destination for Chinese overseas direct investment, according to the MERICS report by Hanemann and Huotari (2016) as shown in the map on page 11.

In 2015 alone, Ping An Insurance and Tai Kang Life, two of China's major insurance companies, successfully bid for real estate projects in London, with a total value exceeding US$5 billion. The popularity of British commercial real estate among Chinese investors is unsurprising. Chinese companies continually choose to base their European headquarters in London due to its attractive position as a gateway to the rest of Europe.

However, once the UK loses access to the EU single market as is expected post-Brexit, it is also expected to lose some of its attractiveness as a Chinese investment hub in Europe. It follows that this will impact Britain's commercial real estate sector, as trade and investment uncertainties between the UK and the EU increase.

"Chinese companies that use Britain to gain access to the EU market will encounter fresh issues including tax, labor mobility and legal aspects," He Weiwen, a researcher at Renmin University in Beijing, told *Global Times*, China's English-language newspaper. "These companies will consider setting up additional offices in the European continent," he adds.

Furthermore, if London were to lose a share of its EU-related financial operations to cities like Frankfurt and Paris post-Brexit, the city would also gradually lose its current advantage as a regional finance hub. China would turn to other countries on the continent which already hold a significant share of its EU investment such as Italy, France, and Germany.

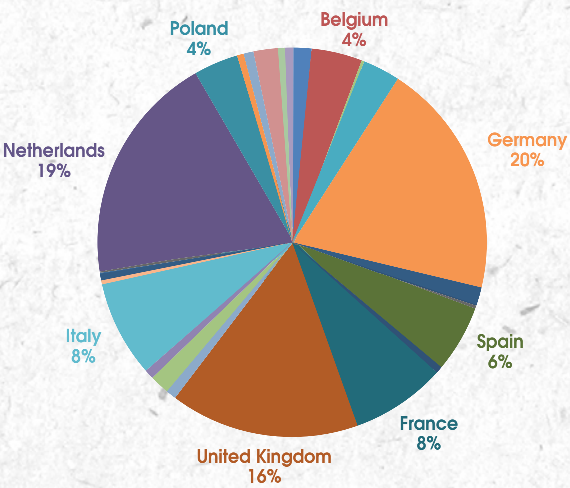
China's RMB strategy

Brexit may also temporarily slow China's RMB internationalization strategy. As the second largest global renminbi offshore market after Hong Kong, London currently has the largest renminbi pool in Europe and has hosted several yuan bond floats. This includes the May 2016 RMB3 billion (US$451 million) sovereign bond issued by the Chinese government on the London Stock Exchange – the first ever renminbi bond to be issued outside of China.

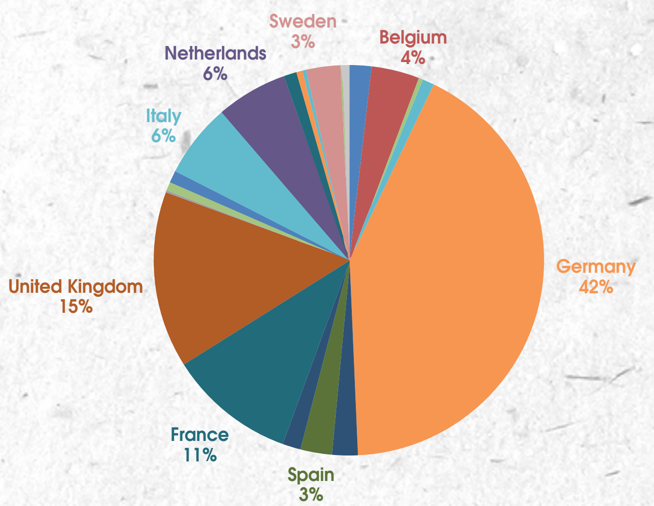
Andrew Carmichael, capital markets partner at international law firm Linklaters, which advised China on its landmark bond issue, told Hong Kong's *South China Morning Post* in June: "Being part of the EU and able to offer financial services to the rest of the EU means that Chinese banks based in London can operate all over the EU. This makes London an attractive center to develop offshore renminbi activities."

China's foreign trade with the EU countries

China's Export to the EU (2015)



China's Imports from the EU (2015)



Source: Bruegel and Eurostat

However post-Brexit, “it could be more difficult for London-based banks to market and sell inside the EU, and there may be restrictions on EU investors’ ability to buy renminbi products issued in London,” Carmichael continued. If this proves to be true, China may be forced to relocate its renminbi services to other cities on the European continent.

Where trade is concerned, China has always viewed its relationship with the UK as a gateway towards deepening existing trade relations with other EU member states. Following Britain’s exit from the single market however, China may once again turn towards a different member country in order to achieve its goals. How easy or difficult this may prove remains to be seen.

On the other hand, China would be in a much better position to negotiate its own FTA with an independent UK post-Brexit, taking advantage of its rosy relationship with Britain, which has entered into what former UK Prime Minister David Cameron famously called a “golden era” during his visit to China in 2013.

Scenario 2: A more united EU

In Brussels – de facto capital of the EU – Britain is seen as a liberal, free-trading advocate of the open market; its presence plays a weighty role in neutralizing the pressures applied by more protectionist forces in the EU bloc. Once Britain leaves, the current political power balance will likely undergo a shift, giving new momentum to protectionist policies which have been mostly discouraged thus far, leading to a more united but potentially less open Europe.

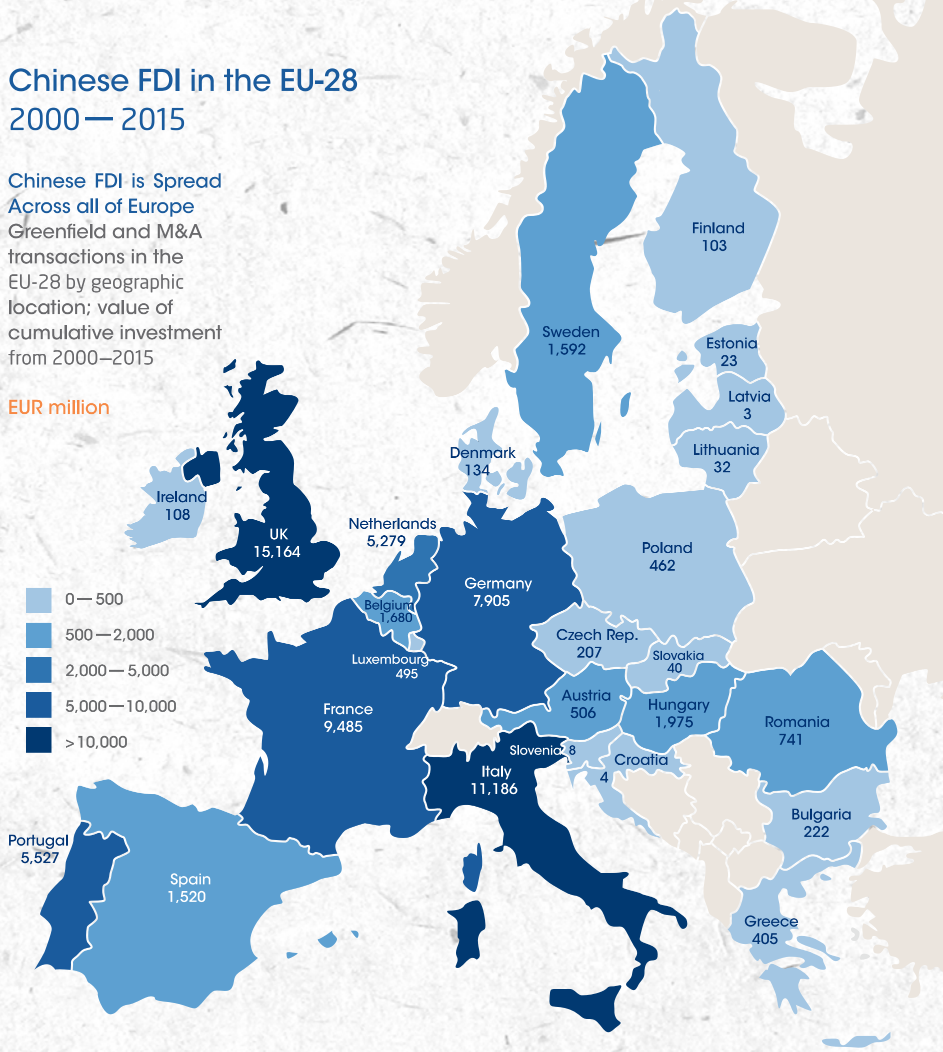
Under these circumstances, China would have much more at stake, including the continuity of its strong trade relations with Germany on equal terms. In 2015, the total value of EU imports into China was just over US$200 billion, of which imports from the Deutschland made up the 42 percent majority.

As the largest global beneficiary of Europe’s open, free-trade market policies, China’s import/export industry may suffer if new protectionist policies are implemented post-Brexit. Furthermore, the prospect of negotiations with a tougher EU may require more compromise from China’s end than it is willing to make.

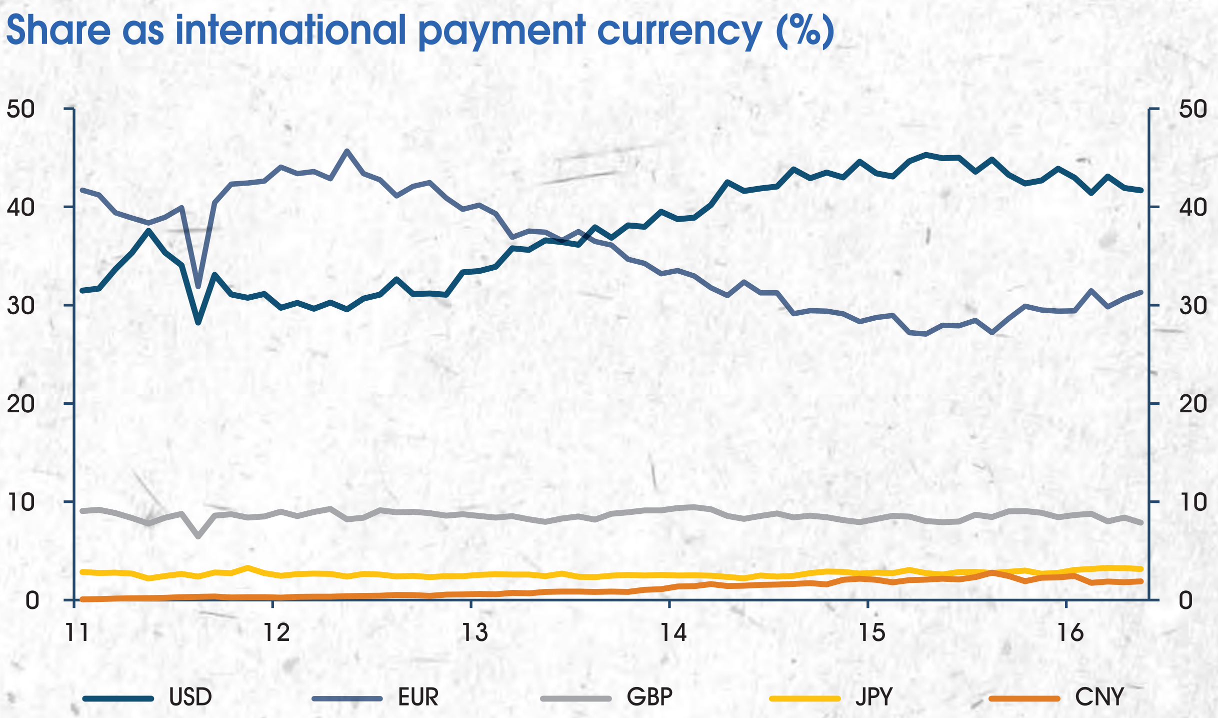
Another challenge for China with a less-open EU market affects its RMB internationalization strategy. In light of London’s diminishing attractiveness as a financial hub, China’s search for a substitute RMB offshore center in continental Europe could prove more challenging in the event that a more united and protectionist EU: 1) makes it difficult for China to penetrate the market, and 2) strengthens the euro as an international currency, challenging the renminbi’s growing global influence.

While a more united EU could in theory present a very undesirable scenario for China, in reality this will depend on whether the EU decides to take a more protectionist stance; the extent of which remains to be seen. But all in all, not the best outcome that China can hope for.

Chinese investment in the EU



Source: A New Record Year for Chinese Outbound Investment in Europe – a Report by MERICS and Rhodium Group



Source: Natixis

According to estimations by Natixis, China's GDP for 2017 is forecast to be lower by 0.2 percentage points following Brexit with a more united EU, compared to a situation in which Brexit does not take place at all.

Scenario 3: A fragmented EU

A possible – although much less likely – scenario proposed by Herrero involves fragmentation of the EU following Brexit. Other member states who may have been harboring feelings of discontent or a wish to leave themselves may feel emboldened by Britain's exit, spawning disunity within the economic community.

In spite of this, the likelihood of other EU member states following Britain's precedent in reality is slim, as the financial costs alone would be monumental, especially for those states that have adopted the euro as currency. An exit would require their assets and liabilities to be re-denominated back into their original currencies, for example – a costly procedure.

However, a fragmented Europe would work in China's economic favor, placing it in a stronger position to negotiate terms with individual EU member states. On the global political stage, China's weight would certainly increase, particularly regarding issues related to trade and investment.

Alicia Garcia Herrero

This scenario would also go a long way towards supporting RMB internationalization, as EU fragmentation would see the pound and the euro weaken as preferred settlement currencies, lending more global weight to the renminbi as a result.

While the immediate impact of June's Brexit vote on China's financial market has been minimal, the medium- to-long term economic implications for the country will depend on two things: the negotiated outcome of Article 50 talks outlining the new nature of UK's relationship with the EU, and more importantly, EU's reaction to Brexit.

In the meantime, China would do well to hedge its bets by continuing to nurture its existing political and economic relationships with all parties, while building ties with new ones – both within and outside the EU.

Other than that, like the rest of world, all China can do is wait.