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Impact of Brexit on China depends on Europe's unity

Since the UK referendum on Brexit, we are still trying to settle the dust after the storm. The impact so far has been on financial assets but the real question is how much of that will persist over time. During the last few years, the UK has experienced some kind of love affair with China. Cameron himself visited China at the end of 2013 and proposed the Chinese authorities to engage in negotiations for a Free Trade Agreement (FTA) with China. More recently, Xi Jinping visited London to foster strategic cooperation against the backdrop of increasing Chinese FDI into the UK.

This note aims at evaluating what may be the effects of Brexit on China beyond the immediate effects. After a short account of the short term impact, we develop three scenarios on Brexit's impact on EU to evaluate the medium term impact of Brexit on China (from 2017 to 2020). The scenarios are: (1) status quo for EU; (2) a more integrated/united EU; and (3) a fragmented EU, which could mark the end of EMU and perhaps even EU. The impact on the Chinese economy should be trivial in Scenario 1, moderate in Scenario 2, and detrimental in Scenario 3. However, China would gain the political center stage under Scenario 3, which would eventually – although not immediately – moderate the harm that a fragmented EU will cause on the global economy, including China. These scenarios are obviously not equally likely (the first and second obviously being more) but it is also very difficult to assign probabilities given the current level of uncertainty. A final point to clarify is that all of these scenarios do include a full exit of Britain from the EU.

The Immediate impact – mainly mild CNY depreciation

Global markets have reacted moderately to the Brexit referendum. At least, there was nothing similar to a liquidity crisis. In the case of China, we cannot even talk of liquidity tightness in the money market. One could think that this is related to the tight capital controls but it actually has also been the case in the rest of Asia without such controls.

The immediate impact of the Brexit referendum on China has been a mild depreciation of the yuan against the dollar of 0.62 % and a moderate fall in the CSI300 stock index of -1.22%. Compared to other Asian currencies, the drop of the yuan was minor but it still augurs that, under a risk-off sentiment, pressure for capital to leave will continue in the coming months. However, China's partial closeness of the capital account will continue to limit such outflows.

Longer term impacts depends on the unity of EU

Beyond the more immediate effects of BREXIT on China, the size of EU is relevant enough to have longer term impacts on China. Furthermore, EU remains one of China's largest trading partners and a very important destination of outward FDI (OFDI). China has also received large amounts of FDI from EU although the trend has moderated in the last few years.

To better assess the medium term impact of BREXIT on China, we need to consider a number of different scenarios related to the EU once Britain leaves.

1. Status Quo:
   Once the next UK Prime Minister activates Article 50 of the Lisbon Treaty, the EU negotiates a bilateral agreement with UK which leaves the situation pretty much as it is today.

2. Brexit with a more united EU:
   Britain's exit creates more unity among existing EU member states, not only in terms of economic but also political integration. In that case, both China and the UK will face a tougher EU in negotiations amidst stronger protectionism. This negative impact will be mitigated through the positive growth channel of an economically stronger Europe.

3. Brexit with a fragmented EU
   Brexit becomes a catalyst for economic fragmentation in Europe. The driver could be populism. This would eventually bring an end to EMU and, potentially, even EU. This should not only lower EU countries' potential growth further but should also be detrimental for globalization and global growth.

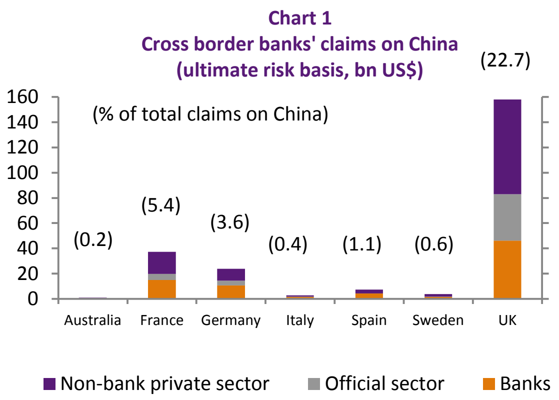
The next step is to analyze how China may be affected in each of the above scenarios.

Scenario1 – Status Quo

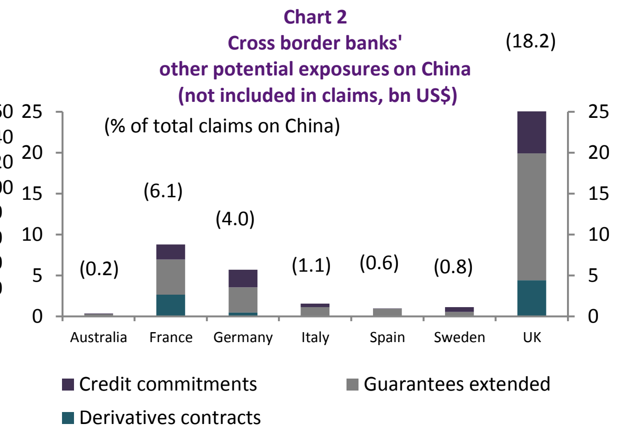
Under this scenario, we confine our discussion to the UK-China tie as we assume is no change in EU's behavior. We focus on three aspects, namely portfolio flows, trade and FDI. It goes without saying that the UK will eagerly seek cooperation with China in any of the three aspects but its negotiation power will be low. This means that terms of a bilateral agreement between UK and China would inevitably be favorable for China given the UK reduced bargaining power as it no longer serves as the entry point to the rest of the Europe.

Funds flows – Set up an offshore RMB hub in EU, more Chinese banks across Europe

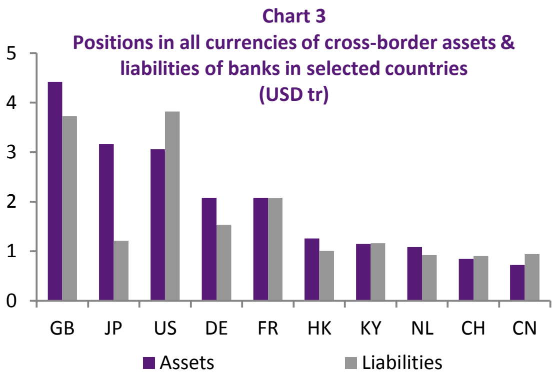
According to the BIS, as shown in **Chart 1 and 2**, British banks play a very important role in cross border banking transactions. Before Brexit, banking and financial products in the UK have access to EU customers. However the access to the wider EU market would no longer exist after UK leaving the EU unless the UK manages to negotiate it (obviously at a price). Without the European single passport, foreign banks in the UK would need to apply for banking licenses to setup business in the EU and Chinese banks would obviously be affected. Claims on the Mainland by banks domiciled in the UK amounted to $158 billion at the end of 2015, which is equivalent to 1.5% of China nominal GDP ($10557 billion). It is likely the creditors of the claims to Chinese entities booked in the UK were corporates and banks in EU. Another relevant point for China is that Euroclear would probably move from UK to EU, which would significantly affect the role of London as a financial center (**Chart 3 and 4**).



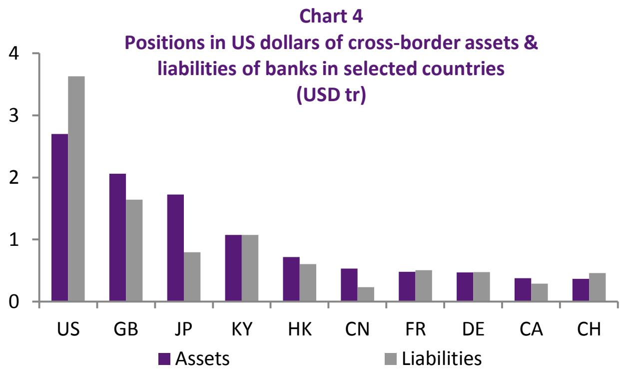
Sources: BIS, Natixis



Sources: BIS, Natixis



Sources: BIS, Natixis



Sources: BIS, Natixis

CA = Canada; CH = Switzerland; CN = China; DE = Germany; FR = France; GB = United Kingdom; HK = Hong Kong; JP = Japan; KY = Cayman Islands; NL = Netherlands; US = United States.

The relocation of Euroclear, among other reasons, could affect China's support for London as European offshore center for the RMB. Since 2009, the kick-off of RMB cross border trade settlement, the yuan has become the sixth most used currency in international payments according to SWIFT. In 2014, UK accounted for two thirds of RMB trading outside China and Hong Kong[1]. It is very likely that China will find another city in Europe to develop offshore RMB businesses so that it can have access to the bigger market.

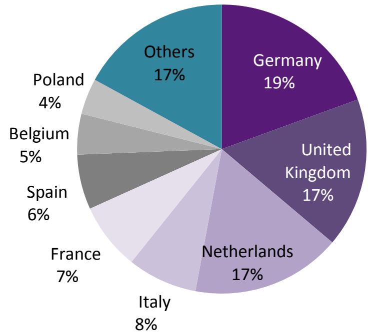
Among all the European countries, second to the UK were French banks that had $37 billion of ultimate Mainland risk in 2015 (**Chart 1**), which is equivalent to 0.35% of China GDP. The size was less than one-fourth of UK banks. German banks have an even smaller share. France and Germany are the likely candidates to compete to create the next offshore RMB hub in Continental Europe. This would give China direct access to the EU market on its offshore RMB business further facilitating trade.

To illustrate how Brexit would affect the landscape of China-UK/EU fund flows, let's look at the country composition of the RQFII quota. As of June 29th 2016, UK, France, Luxemburg and Germany have taken 5.8%, 4.1%, 2% and 1.3% of the total quota, respectively (**Table A1 in Appendix**). As some asset management companies in the UK may setup subsidiaries in the continental Europe later, the UK quota of RQFII is bound to be reduced.

Trade flows – trivial impact only

UK is the second largest export destination of China in Europe (**Chart 5**) but it is still relatively marginal (**Chart 6**) for China (2.6% of China's total exports), and even less so as import origin for China (**Chart 7 and 8**). In this status quo scenario in which growth in the rest of Europe is not affected, China's exports should not really feel the brunt of Brexit too much. Furthermore, the UK will probably be very keen in signing a bilateral agreement with China, which should – ceteris paribus– increase Chinese exports into the UK. This is especially the case if the EU and UK do not manage to reach a trade deal as comprehensive as it is today.

Chart 5
China's top EU export destinations (2015, US$ bn)

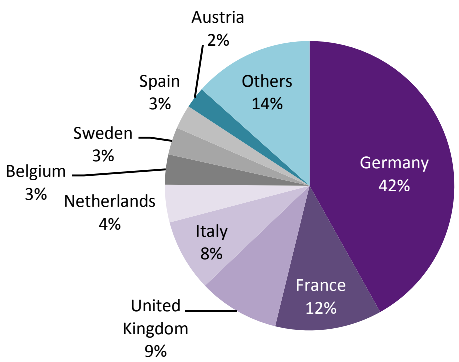


Sources: Bloomberg,Natixis

Chart 6
China's top export destinations (2015, US$ bn)

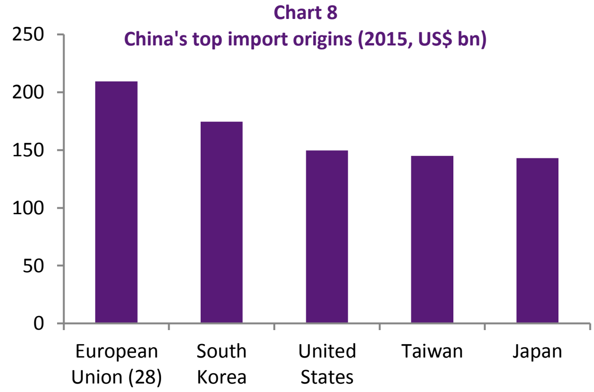
Sources: Bloomberg,Natixis

Chart 7
China's top EU import origins (2015, US$ bn)



Sources: Bloomberg,Natixis

Chart 8
China's top import origins (2015, US$ bn)

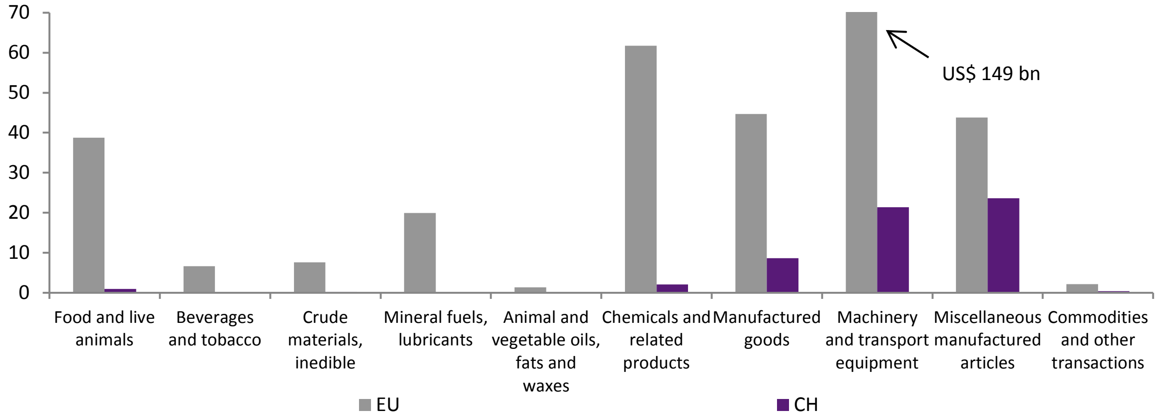


Sources: Bloomberg,Natixis

[1] https://www.gov.uk/government/speeches/first-uk-china-financial-forum-chancellor-speech

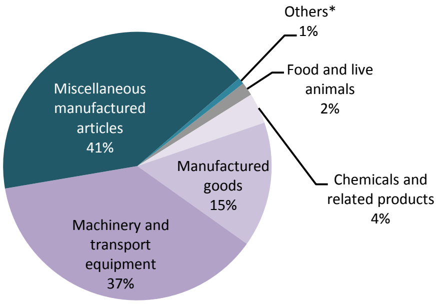
The sectors to which China exports to the UK are not very different from China's exports to other countries in EU, namely Machinery and transport equipment, and manufactured goods, so the sector impact is limited (**Chart 9,10 and 11, Table A3 A4 in Appendix**). We expect some China-UK trade flows would be started to divert to China-EU (ex UK) as corporates would start their contingency on Brexit.

Chart 9
China and EU exports to the UK in 2014 (US$ bn)



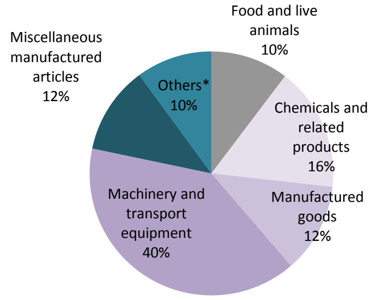
Sources: UNCTAD,Natixis

Chart 10
China's exports to the UK by types of goods (2014)



**Others include beverages, tobacco, crude materials, mineral fuels and oils*
Sources: UNCTAD, Natixis

Chart 11
EU's exports to the UK by types of goods (2014)



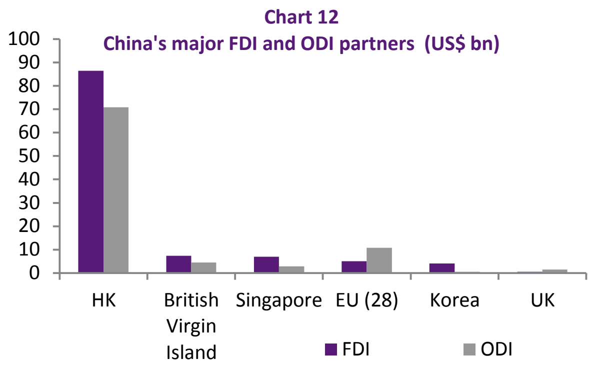
**Others include beverages, tobacco, crude materials, mineral fuels and oils*
Sources: UNCTAD, Natixis

In any event an FTA between China and UK would not happen overnight. China so far has signed two FTAs with European countries, namely, Iceland and Switzerland, and the FTA with Norway is still under negotiation since September 2008 (**Table A2 in Appendix**). Referencing the time that China took to discuss FTAs with Iceland and Switzerland, which were more than 8 years and 3 years, respectively, we expect that it could take more than 2 years for China and UK to sign their bilateral FTA.

Looking forward in 2017, our house view forecast on the UK and Eurozone GDP post Brexit are 1.6 and 0.2 percentage points lower than no Brexit respectively. This means that these economies would import less from the rest of the world including China. We estimate such direct impact on China's exports to be minor (0.1 percentage point). For the longer term, up to 2020, the likely signing of a bilateral FTA between UK and China should increase exports from China into the UK. This is why we find such status quo scenario relatively good for China.

Investment flows – too small for China to feel the heat if not better

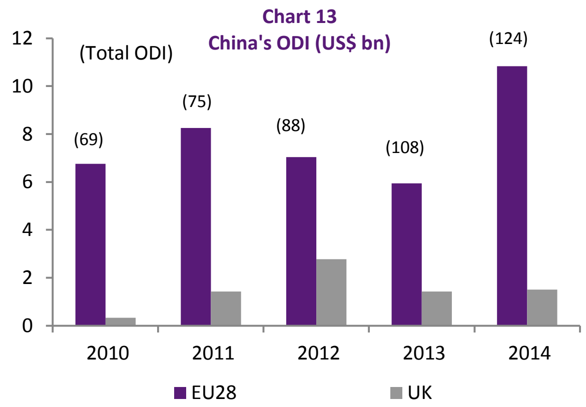
This issue needs to be divided in two separate ones, first FDI from UK into China and, second FDI from China into UK. As regards the former, the amounts are already close to insignificant for the size of the Chinese economy and the UK economic deceleration – if not recession – post Brexit can only reduce it. More specifically, and although the amount might be underestimated as part of the FDI from Hong Kong may actually come from UK, it officially was only 496 million in 2015, very small even when compared to the FDI from the rest of EU (**Chart 12**).



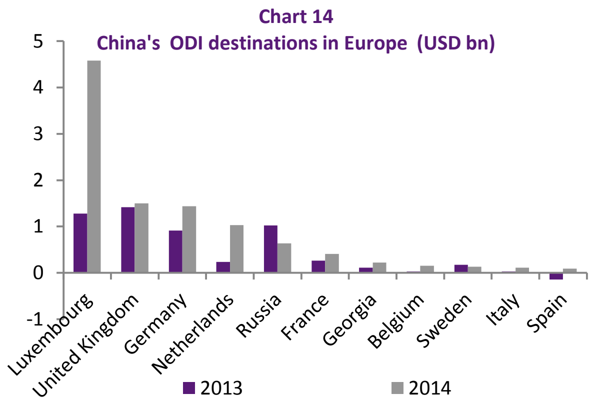
FDI data as of 2015; while ODI 2014
Sources: CEIC, Natix

More generally, China may even end up receiving more FDI as investment projects from the rest of the world into UK and EU could be suspended. In fact, multinationals might rethink their business plan post-Brexit although this is clearly more obvious in our third scenario (EU fragmentation) than in a status quo one.

FDI from China into UK should also come down as the UK economy stagnates and loses the access to the EU single market. Even if an agreement were to be negotiated with the UK, there will surely be some degree of "wait-and-see" by Chinese corporates. Given the fact that the UK is already the largest recipient of FDI from China today (mainly in commercial real estate), it seems difficult for the UK to keep that role (**Chart 13 and 14**), which was illustrated in MERICS's 2016 report on Chinese outbound investment in Europe.



Sources: CEIC, Natixis



Sources: CEIC,Natixis

Overall impact – Only marginal for China in 2017

In sum, the impact of Brexit on China in a status quo scenario is limited and not necessarily be negative for China. Within the marginal impact, the clearest one in the short run is a reduction in exports by -0.1 percentage point. In terms of fund flows, we expect China to add extra offshore RMB center(s) in continental Europe (France or Germany) so as to have access to the EU market. FDI from UK is too small for China to feel the pain. However, a reduction in FDI from China into the UK, which has been quite substantial in the last few years for the size of the UK economy, is to be expected. All in all, Brexit with a status quo situation on EU could at most have -0.1 percentage point reduction of China's GDP growth in 2017 (**Table 1**). Looking forward to 2020, as business opportunities would arise with a China-UK FTA among other initiatives, China might even benefit from Brexit.

Table 1: Forecast of China's GDP with a status quo EU

2017	UK GDP	Eurozone GDP	China GDP
Without Brexit	2.1	1.4	6.7
Brexit but status quo for EU	0.5	1.2	6.6

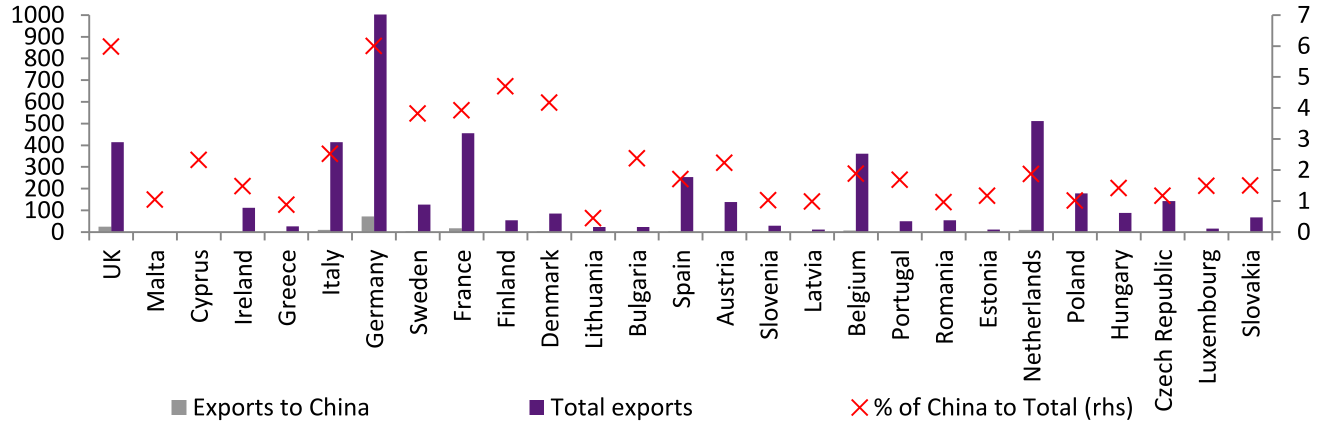
Scenario 2 - Brexit with a more united EU

In this scenario, both China and the UK will face a tougher EU in terms of negotiations for two reasons. First, being more integrated, the EU will also hold as China can no longer use the policy of divide and conquer. Even more so, the exit of Britain, long considered to have balanced the protectionist forces coming from the continent, especially from France, should lead to a less open Europe. China is the largest beneficiary of economic openness at the global level so it is bound to lose from a less liberal EU. Trade barriers may be built between China and EU. Germany, with deeper trade links with China and China itself should lose. Small countries in general (e.g. Luxemburg and Slovakia) are better shielded from deteriorating economic links between China and the EU given their low share of exports to China (many have less than 2% of total exports)(**Chart 15 and 16**).

A stronger and a more protectionist EU should put additional brakes into the UK-EU relations, thus increasing China's negotiating power for an FTA with the UK even more than in Scenario 1.

Chart 15

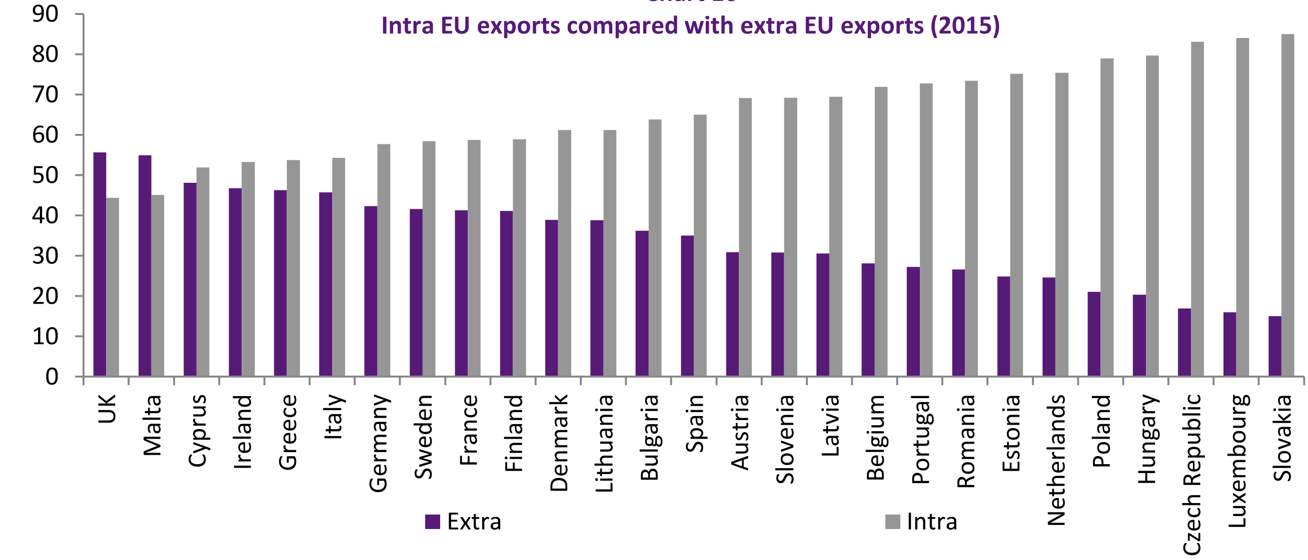
Total exports and exports to China (EUR bn)



Sources: Eurostat, Natixis

Chart 16

Intra EU exports compared with extra EU exports (2015)



Sources: Eurostat, Natixis

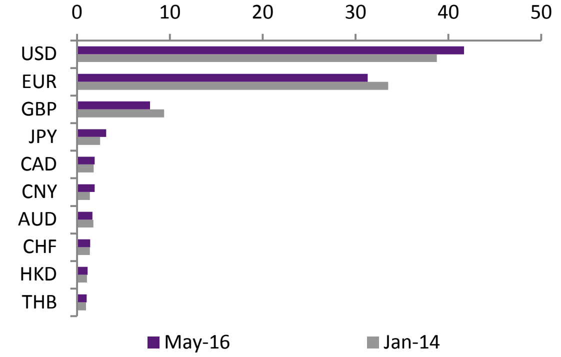
In the same vein, a stronger but a more protectionist EU would probably create headwinds for China FDI into EU, which have shown marked progress over the years. This comes at a time in which the bilateral investment agreement between the two countries has not yet been signed so there is not yet an agreed negative list of sectors in which FDI cannot take and likely increase the room for pervasive protectionism. This also means a reduction in EU's FDI into China (US$ 10.8 bn in 2015) (**Chart 12**). For both economies, protectionism would only hurt them as trade volume and investment projects may shrink. The scale of the impact depends a lot on the intensity of the confrontation.

Concerning RMB internationalization, the realization of Brexit and a more united EU would bring the worst outcome for RMB internationalization. In fact, a substitute for London in Continental Europe could be less viable. The case of the US today, with no offshore center for RMB settlements is a good example of it. Furthermore, a stronger EU would probably try to strengthen the euro as international currency, which would bring additional challenges to the RMB becoming an international currency. Currently, the Euro takes up about 31% of the total share in May while RMB merely constitutes less than 2% of the settlement, according to SWIFT (**Chart 17**).

All in all, this scenario with a stronger – more protectionist –Europe should be worse for China than that of the status quo. Any estimate of the growth impact can only be very rough and dependent on the degree of protectionism. In an illustrative way, we estimate China's growth to come down 0.2 percentage points in this scenario (**Table 2**).

Chart 17

Share as international payment currency (%)



Sources: SWIFT, Natixis

Table 2: Forecast of China's GDP with a more united EU

2017	China GDP
Without Brexit	6.7
Brexit with a more united EU	6.5

Scenario 3 - Brexit with a fragmented EU

Another potential – although less likely – reaction of the EU to Brexit is fragmentation. Many countries already suffer from a populist threat which could aggravate with Brexit. Some of the populist parties in Europe are calling for referenda to decide whether to remain in EU (France and the Netherlands to start with). If some countries finally decide to exit – the fragmentation process would continue. This is particularly worrisome in the case of an euro-area country. The reason why this scenario is much less likely, though, is related to the huge cost of such exits. Brexit has actually been instrumental in reminding politicians in EU countries how costly an exit may be. In the case of euro area countries, the cost can only multiply as assets and liabilities would need to be re-denominated in a different currency. But, how disastrous the impact would be on China depends on how fragmented of the E.U. would become.

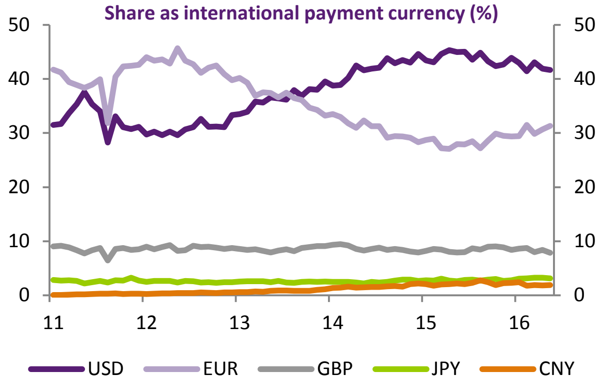
If there were only a couple of countries leaving the EU, then China could still play divide and conquer strategy. China would have the bargaining power to negotiate better terms with individual European countries. However, this comes on top of a negative global impact of a fragmented Europe, the key channel being uncertainty and its impact on financial markets. Politically, if EU is fragmented, China will be more powerful in the global political stage, which would also mean stronger economic power, i.e. stronger bargaining power in the terms of trade agreements and investment preferential agreements. As more exits come about, multinationals would divest their investments in the EU.

The impact on RMB internationalization is again, as we argued before, dependent on the degree of fragmentation of the EU - higher the dispersion, greater the chance Renminbi can sparkle on the international stage. Interestingly enough, the reducing importance of EUR and GBP as settlement currencies has started way before Brexit. Since 2012, the share of EUR headed south steadily (**Chart 18**), the same applies to the GBP, albeit at a much smaller extent (Jan-2012: 9%; May-2016: 7.9%) and fragmentation would only catalyze and intensify these trends. Apart from the yuan, another beneficiary should be JPY, which has seen its share increased by 0.7% percentage point to 3.2% between 2012 and May 2016.

If the unlikely event that the number of exit were large to an extent that there could be a breakdown of the Eurozone, European economic growth would be severely affected and thereby the global economy and, of course, China. This scenario is the worst of all for China. This cost will certainly outweighs the potential benefits of China being able to negotiate better with each of the key member states in EU once they are not bound by EU trade or investment policies. GDP growth could slow to 5.5% in 2017 (**Table 3**).

All in all the impact of limited fragmentation could be similar to Scenario 1 and 2 but certainly much worse in the latter case.

Chart 18.
Share as international payment currency (%)



Source: SWIFT. Bloombera. Natixis

Table 3: Forecast of China's GDP with a severely fragmented EU

2017	China GDP
Without Brexit	6.7
Brexit with a severely fragmented EU	5.5

Conclusion: The impact of Brexit on China is limited and China should grab the opportunity to shine

Global markets reacted moderately to the Brexit referendum. With regards to China, the immediate impact is only mild depreciation of the CNY and liquidity tightness in the money market is nowhere in sight.

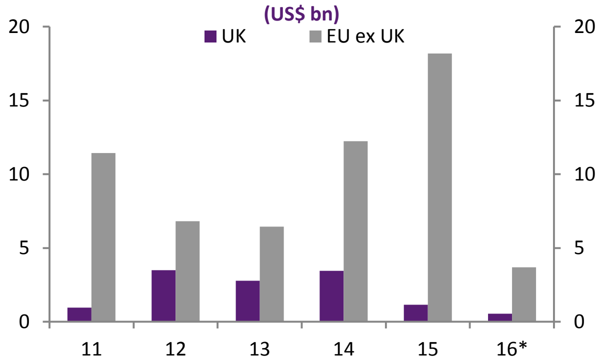
In longer timeframe, the impact of Brexit on China largely depends on the degree of unity of the EU. A scenario with EU's unity pretty much as it is today has limited impact on China and is not necessarily negative for the country. We expect a reduction in exports that could wash away 0.1 percentage point growth from China's GDP growth in 2017. One can also expect new offshore RMB center(s) to be established in Europe. Looking forward to 2020, as business opportunities would arise with a China-UK FTA among other initiatives, China might even benefit from Brexit.

A more protectionist Europe should be worse for China. Any estimate of the growth impact can only be very rough and dependent on the degree of protectionism. In an illustrative way, we estimate China's growth to come down 0.2 percentage points in this scenario.

The worst scenario for China would be the unlikely event that the number of exit were large to an extent that there could be a breakdown of the Eurozone as European and global economic growth would be severely affected. This cost will certainly outweighs the potential benefits of China getting better terms of trade with each EU member. GDP growth could decelerate to as low as 5.5% in 2017.

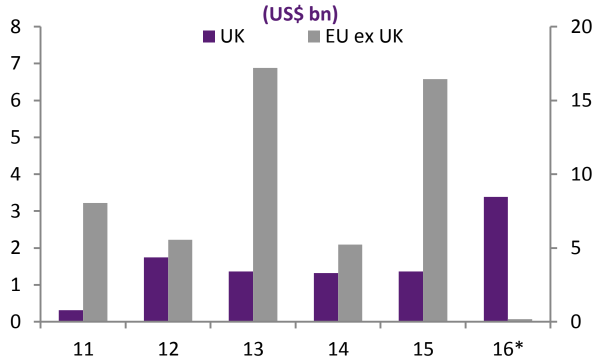
Appendices:
Additional charts and tables illustrating economic and financial interactions between China and UK/EU.

Chart A1
China M&A and Investment into UK and EU (US$ bn)



Source: Bloomberg, Natixis

Chart A2
UK and EU M&A and Investment into China (US$ bn)



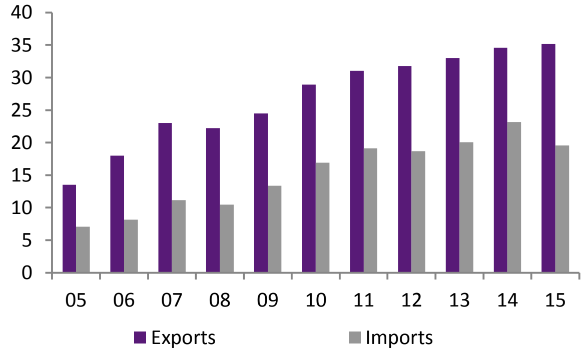
Source: Bloomberg, Natixis

Table A1: RQFII approved quota by region

	Approved quota (CNY bn)	% of total
Total	502	100
Hong Kong	270	53.8
Singapore	55	10.9
UK	29	5.8
France	21	4.1
S. Korea	74	14.7
Germany	7	1.3
Australia	30	6.0
Switzerland	5	1.0
Canada	2	0.4
Luxemburg	10	2.0

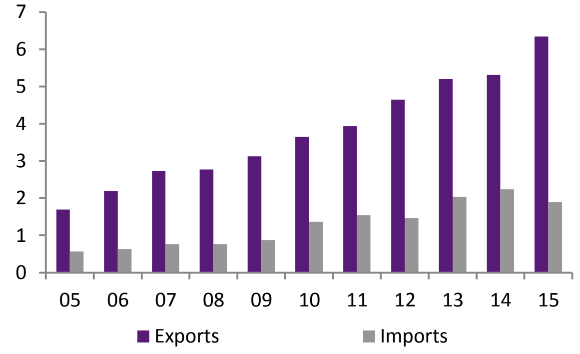
Sources: SAFE, Natixis

Chart A3
China's trade with EU28 (US$ bn)



Sources: Bloomberg,Natixis

Chart A4
China's trade with UK (US$ bn)



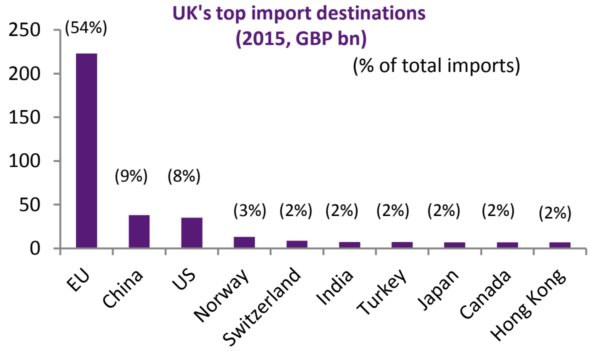
Sources: Bloomberg,Natixis

Table A2. China's regional trade agreements (RTAs)

1. Existing RTAs	Nature	Date concluded
China-New Zealand FTA	Bilateral-developed country	Apr-2008
China-Singapore FTA	Bilateral-developed country	Oct-2008
China-Iceland FTA	Bilateral-developed country	Apr-2013
China-Switzerland FTA	Bilateral-developed country	Jul-2013
China-Korea FTA	Bilateral-developed country	Jun-2015
China-Australia FTA	Bilateral-developed country	Jun-2015
China-Chile FTA	Bilateral-developing country	Nov-2005
China-Pakistan FTA	Bilateral-developing country	Nov-2006
China-Peru FTA	Bilateral-developing country	Apr-2009
China-Costa Rica FTA	Bilateral-developing country	Apr-2010
Mainland and Hong Kong Closer Economic and Partnership Arrangement	Domestic	Mar-2003
Mainland and Macau Closer Economic and Partnership Arrangement	Domestic	Mar-2003
China-ASEAN FTA	Multilateral	Nov-2014
China-ASEAN FTA Upgrading Protocol	Multilateral	Nov-2015
2. RTAs under negotiation		**Negotiations began from**
China-Norway FTA	Bilateral-developed country	Sep-2008
China-Sri Lanka FTA	Bilateral-developing country	Sep-2014
China-Georgia FTA	Bilateral-developing country	Dec-2015
China-Maldives FTA	Bilateral-developing country	Dec-2015
China-GCC(Gulf Cooperation Council) FTA	Multilateral	Jul-2004
Regional Comprehensive Economic Partnership, RCEP	Multilateral	May-2013
China-Japan-Korea FTA	Multilateral	Aug-2013
3. RTAs under consideration		**Joint feasibility study began from**
China-Columbia FTA Joint Feasibility Study	Bilateral-developing country	May-2012
China-Fiji FTA Joint Feasibility Study	Bilateral-developing country	2015
China-Moldova FTA Joint Feasibility Study	Bilateral-developing country	Jan-2015
China-NePal FTA Joint Feasibility Study	Bilateral-developing country	Mar-2016
China-India Regional Trade Arrangement Joint Feasibility Study	Multilateral	2003

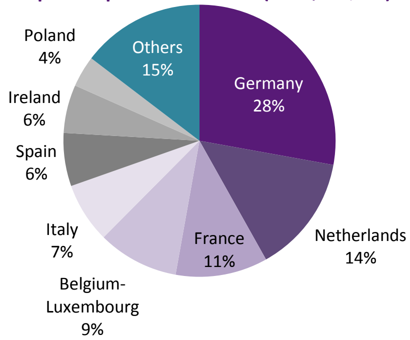
Source: China FTA network, Natixis

Chart A5
UK's top import destinations (2015, GBP bn)



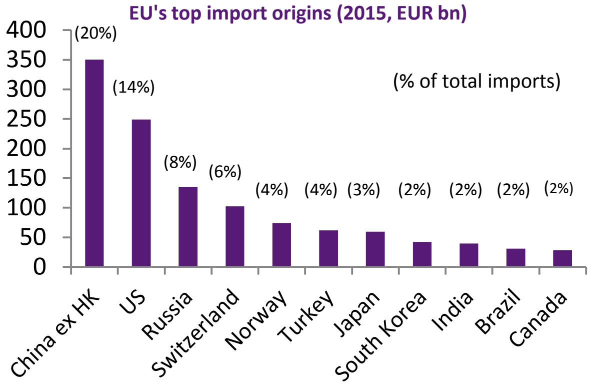
Sources: Bloomberg,Natixis

Chart A6
UK's top EU import destinations (2015, US$ bn)



Sources: Bloomberg,Natixis

Chart A7
EU's top import origins (2015, EUR bn)



Sources: Bloomberg,Natixis

Table A3: Machinery and transport-related exports to the UK in 2014

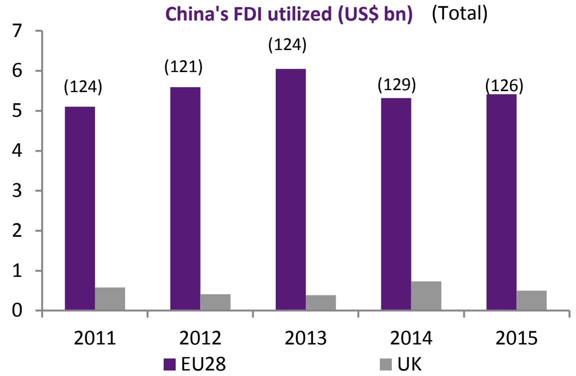
	in %		in US$ mn	
	EU to UK	CH to UK	EU to UK	CH to UK
Metalworking machinery (excludingmachine-tools) & parts	29.6	0.2	401	39
Parts, n.e.s., & accessories for machines of 731, 733	8.2	0.1	275	17
Trailers & semi-trailers	5.9	2.5	823	527
Transmis. shafts	4.8	0.6	1232	133
Vapour generating boilers, auxiliary plant; parts	4.1	0.0	130	3
Telecommunication equipment, n.e.s.; & parts, n.e.s.	3.8	17.2	8757	3691
Printing & bookbinding machinery, & parts thereof	3.2	0.0	350	6
Food-processing machines (excluding domestic)	2.8	0.1	421	12
Sound recorders or reproducers	2.3	1.4	985	305
Other power generating machinery & parts, n.e.s.	2.2	0.2	663	39
Appliances for pipes, boiler shells, tanks, vats, etc.	2.1	2.8	1833	600
Civil engineering & contractors' plant & equipment	1.9	0.8	1785	169
Machine-tools working by removing material	1.8	0.2	577	35

Source: UNCTAD, Natixis

Table A4: Manufactured-related exports to the UK in 2014

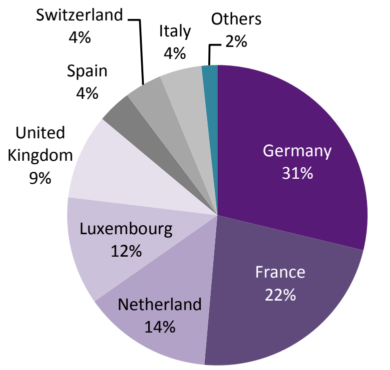
	in %		in US$ mn	
	EU to UK	CH to UK	EU to UK	CH to UK
Paper and paperboard	11.9	1.1	5313	97
Manufactures of base metal, n.e.s.	7.7	11.2	3450	967
Aluminium	5.6	2.5	2522	215
Paper & paperboard, cut to shape or size, articles	5.0	5.1	2251	436
Rubber tyres, tyre treads or flaps & inner tubes	4.9	7.7	2204	663
Silver, platinum, other metals of the platinum group	4.5	0.0	1991	1
Structures & parts, n.e.s., of iron, steel, aluminium	3.7	5.6	1657	482
Copper	3.7	0.8	1653	69
Iron & steel bars, rods, angles, shapes & sections	3.6	1.9	1592	165
Tubes, pipes & hollow profiles, fittings, iron, steel	3.5	2.2	1552	189
Mineral manufactures, n.e.s.	3.1	1.2	1372	102
Flat-rolled products of alloy steel	2.7	1.2	1210	99
Flat-rolled prod., iron, non-alloy steel, coated, clad	2.5	2.2	1108	187

Chart A8
China's FDI utilized (US$ bn)



Sources: CEIC, Natixis

Chart A9
Breakdown of China's FDI from EU (2015, %)



Sources: CEIC, Natix

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