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WHAT DOES BREXIT MEAN FOR CHINA?

If you don't know where you are going, you might wind up someplace else.

Yogi Berra

In the short-term, Brexit has little direct effect on China, except an indirect impact of increasing its financial volatility due to the post-Brexit global financial stress. World stock markets dropped sharply following the Brexit vote on 26 June, except China where its CSI300 A-share index fell by only 1 percent on the following day but only to more than recover it on the subsequent trading day. Like the 2007-08 subprime crisis that weakened the developed economies, Brexit may provide another opportunity for increasing China's global influence at the expense of the developed world[1].

To the extent that Brexit hurts Europe's growth and, hence, international trade, it will also hurt Chinese exports. However, this negative growth impact on China should be limited as its economy is not trade-driven anymore. Since 2009, after the Global Financial Crisis (GFC), net exports have mostly been a drag on, rather than a contributor to, Chinese GDP growth (Chart 1).

During the GFC, China made up for the loss of external demand by implementing a RMB4 trillion (USD56 billion at the then prevailing exchange rate) stimulus package. This aggravated the excessive capacity problem in the manufacturing and real estate sectors and worsened diminishing marginal returns on investment.

But China also made some efforts to rebalance the economy from industrial-based investment towards service-based consumption (Chart 2). GDP growth has held up at more than 6% a year since the current growth slowdown started in 2013, despite all the criticism on China's rebalancing path. Consumption has delivered an average of 4.7 percentage points of GDP growth since 2009 (Chart 3).

[1] See "*The Renminbi Rises: Myths, Hypes and Realities of RMB Internationalisation and Reforms in the Post-Crisis World*", chapter 1, Chi Lo, Palgrave Macmillan, 2013

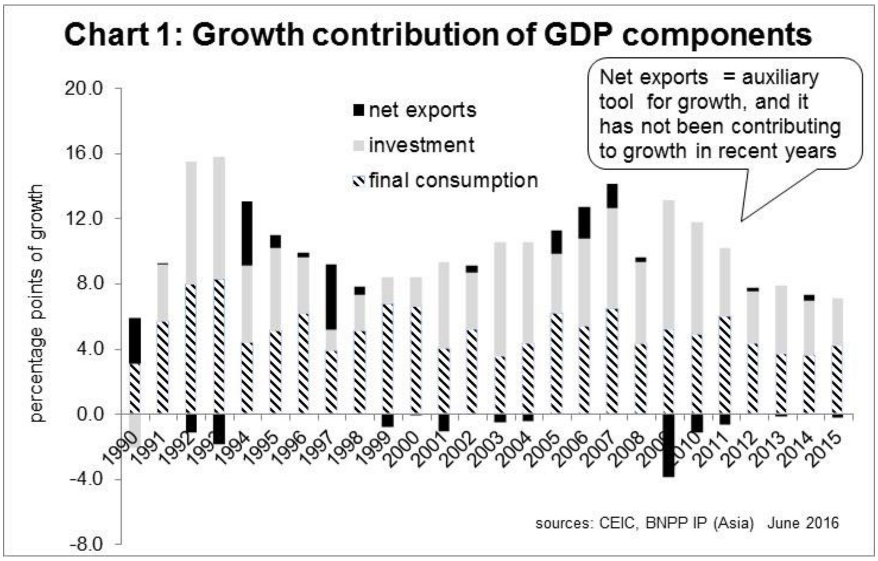
Chart 1: Growth contribution of GDP components
net exports
investment
final consumption
Net exports = auxiliary tool for growth, and it has not been contributing to growth in recent years
percentage points of growth
sources: CEIC, BNPP IP (Asia) June 2016

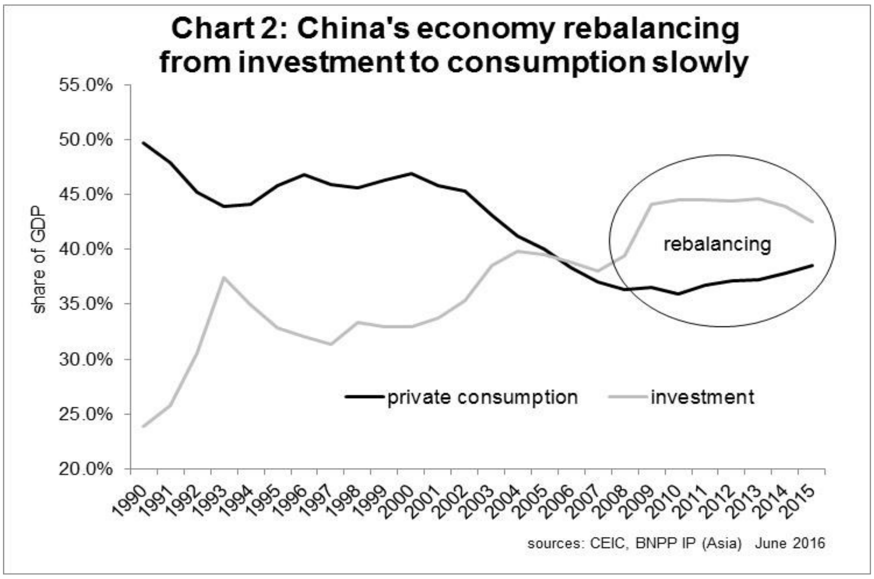
Chart 2: China's economy rebalancing from investment to consumption slowly
rebalancing
private consumption
investment
share of GDP
sources: CEIC, BNPP IP (Asia) June 2016

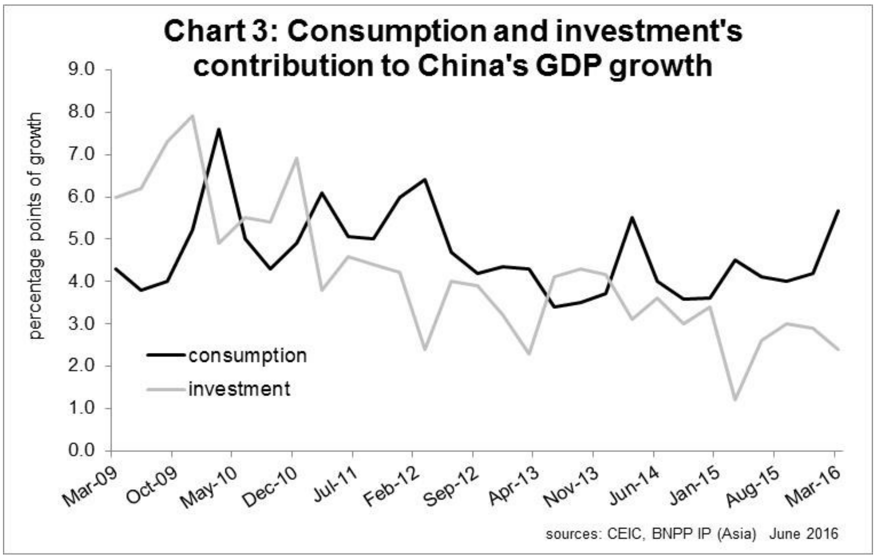
Chart 3: Consumption and investment's contribution to China's GDP growth
consumption
investment
percentage points of growth
sources: CEIC, BNPP IP (Asia) June 2016

The relevance of Brexit weakening the external environment to China's growth is to force China to continue its economic rebalancing effort towards a consumption-based economy. Since consumption is mostly service-based and the service sector is more labour intensive than the industrial and manufacturing sectors, rebalancing towards consumption should help absorb the surplus labour shed from industrial retrenchment. Granted, many things can go wrong in the economic transformation process, but focusing on consumption growth is the right thing to do, not sustaining the external sector where China has little control of foreign demand.

This also argues that renminbi devaluation would not help resolve China's growth problem because it is a result of structural and domestic changes and external demand deficiency. But Brexit does complicate China's FX policy.

China used to be a source of stability by keeping the CNY-USD exchange rate stable. But as the US dollar strengthens against the global currencies, China's FX policy shift since August 2015 from targeting the US dollar to keeping a stable trade-weighted exchange rate has broken the back of the CNY-US dollar stability. This is because Beijing has used the dollar-renminbi cross rate as an adjustment factor for keeping the renminbi's trade-weighted exchange rate stable.

If the US dollar continues to strengthen post-Brexit, *ceteris paribus*, this will push up the renminbi's trade-weighted exchange rate and exert more downward pressure on the dollar-renminbi cross rate. Fears about renminbi devaluation would quickly return, wreaking havoc the global markets. A weakening renminbi may also accelerate capital outflow from China, further complicating the crosscurrents in the global FX market.

So a lot depends on how the People's Bank of China (PBoC) reacts to the US dollar's movement. It still has sufficient tools to manage the capital outflow pressure, in my view, including a tactical FX policy shift between targeting the CNY-US dollar cross rate and the renminbi trade-weighted exchange rate for managing market sentiment.

The PBoC has recently made a tactical policy shift back towards targeting a stable CNY-US dollar cross rate, as it notices that what matters to onshore FX sentiment, which affects capital outflow pressure, was predominately the CNY-US dollar cross rate but not the trade-weighted exchange rate. Such a tactical FX policy shift back and forth between targeting the US dollar and the trade-weighted exchange rate will remain as a tool for the PBoC to manage renminbi sentiment in the medium-term.

Regarding China's overseas investment strategy, the UK has been one of the favoured destinations as it is seen as a jumping board to continental Europe. But China may need to rethink such a strategy after Brexit. The US has been the largest recipient of Chinese foreign investment and Brexit will probably strengthen this trend. Meanwhile, China may also strengthen its Belt and Road initiatives to offset some of the lost investment momentum in the UK and Europe.

As for the UK, it may be keener than before to strengthen its ties with China to make up for some of its economic losses due to Brexit. So it may be willing to make compromises on market-opening and other conditions when negotiating investment and trade deals with China that it would not be able to make by remaining in the European Union (EU).

On a net basis, China seems to gain from Brexit. Europe's influence on the global stage is likely to weaken as it will be tied up with the British exit negotiation and other internal issues, including the possible spread of the Brexit sentiment to other EU members, the control of refugee migration and the urgency of keeping economic and financial stability. These European and other geo-strategic issues, notably in the Middle East, will also likely keep the US on its toes and distract its policy focuses. This environment should give China a window of opportunity to increase its global influence.

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