Brexit Monitor

The Impact on Emerging Markets: Risks vs Opportunities

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Emerging Markets

The Impact on Emerging Markets: Risks vs Opportunities

Over the past months there has been an array of analyses of the effects of the UK's vote to leave EU on advanced economies. In this issue of PwC Europe's Brexit Monitor we would like to look at some implications of Brexit for emerging markets (EMs). The effects on emerging countries will likely be most felt via financial markets as well as through trade and investment channels, and funding opportunities will also be on the agenda.

Financial Markets

The currency and stock markets reacted significantly in the direct aftermath of the Brexit vote. The UK's EU referendum came at a time when EMs were already coping with multiple issues: the US Federal Reserve's expected upcoming move on interest rates, a global economic slowdown, commodity prices and geopolitical tensions in addition to other political uncertainties.

Before entering into country specific details, we can note that the MSCI World Index[1] and the MSCI Emerging Market Index,[2] declined with 4.9% and 3.5% respectively on the day immediately following the UK referendum. However, looking at the performance of those indices after June 2016, it becomes clear that emerging markets positively decoupled from the global benchmark in the months following the vote, with the difference widening further from the end of October.

1 A broad global equity benchmark that represents large and mid-cap equity performance across 23 developed markets countries.
2 An index comprised of 23 emerging countries representing 10% of world market capitalization.

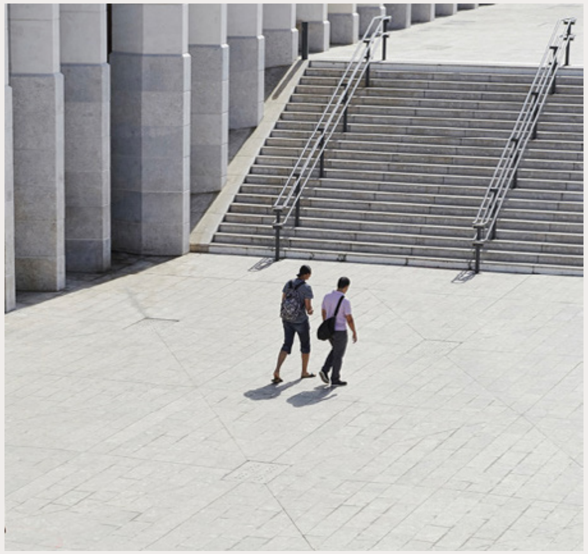
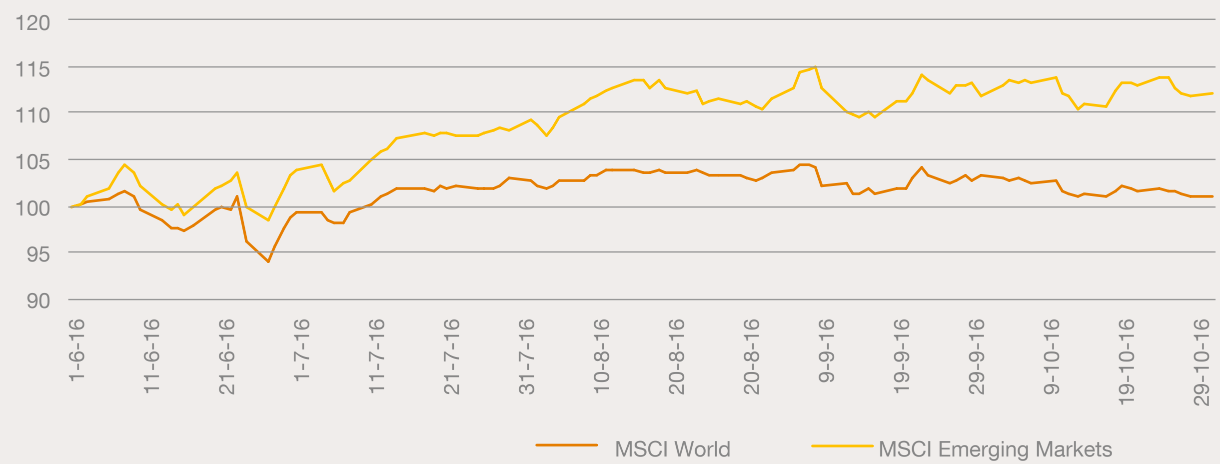


Chart 1 MSCI World and MSCI Emerging Markets indices (1 June 2016 = 100)



Source: Bloomberg, PwC Turkey.

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The external trade position of a country is the major determining factor for its stock market performance ranking. As shown in the next section, the higher the share of exports to the EU27 in a country's overall exports, the bigger was the decline in the stock exchange values. As expected, European EMs stock exchange indices demonstrated the sharpest daily falls among emerging markets following the UK vote.

As the pound sterling was under pressure, all emerging market currencies appreciated against the pound the day after the referendum results. However, at the same time currencies declined in value against the US dollar due to the surprise outcome. Those losses were mostly recovered around the time it became clear that Article 50 would not be trigged until the first quarter of 2017.

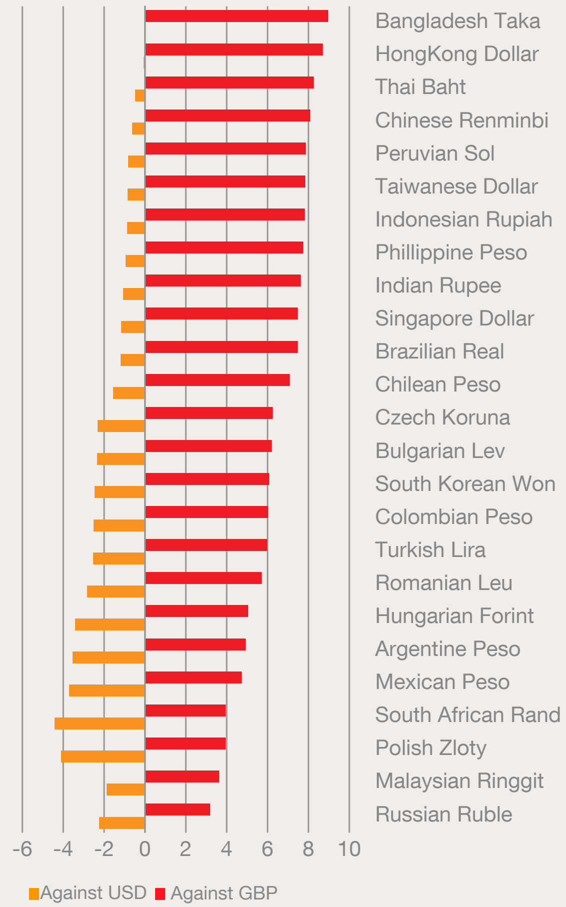
Since there still are many uncertainties around the conditions on which the UK will leave the EU, Brexit has not been fully priced in by investors yet. Hence, once the negotiations begin, political conditions may put pressure on the global financial markets. The question is what will happen in the financial markets once the exit negotiations between the EU and the UK start?

We expect the short- to medium-term effects on EMs to be mixed. Emerging countries that have extensive trade relations with the UK and the EU would be affected most. However, as the leading central banks will be more cautious about normalising monetary policies, we still expect significant capital flows to EMs by yield-seeking investors. The longer-term outlook will, of course, hinge on the final outcome of the negotiations between the UK and the EU, and between the UK and individual EMs.

Chart 2 One day stock market change after the UK's referendum outcome (in %)

Source: Bloomberg, PwC Turkey.

Chart 3 EM currencies one day performance after the UK referendum outcome (in %)



Source: Bloomberg, PwC Turkey.

Trade and Investment

Foreign Trade

The implications of the UK's vote to leave the EU on EMs trade dynamics can be divided into two categories: direct and indirect effects. As the UK economy is expected to slow down in the short term due to uncertainties, the UKs demand for foreign goods is estimated to shrink, which would directly affect those EMs that have a high exposure to the UK in terms of exports.

At an overall level the risk exposure in terms of direct exports to the UK is not very high for emerging markets. However, for some individual emerging markets the share of exports to the UK is significant. At a regional level, European EM's trade with the UK is understandably the highest. And on a country specific level, the UK is the second export destination of Turkey, at 7% of total exports. On average, emerging markets send 3% of their exports to the UK.

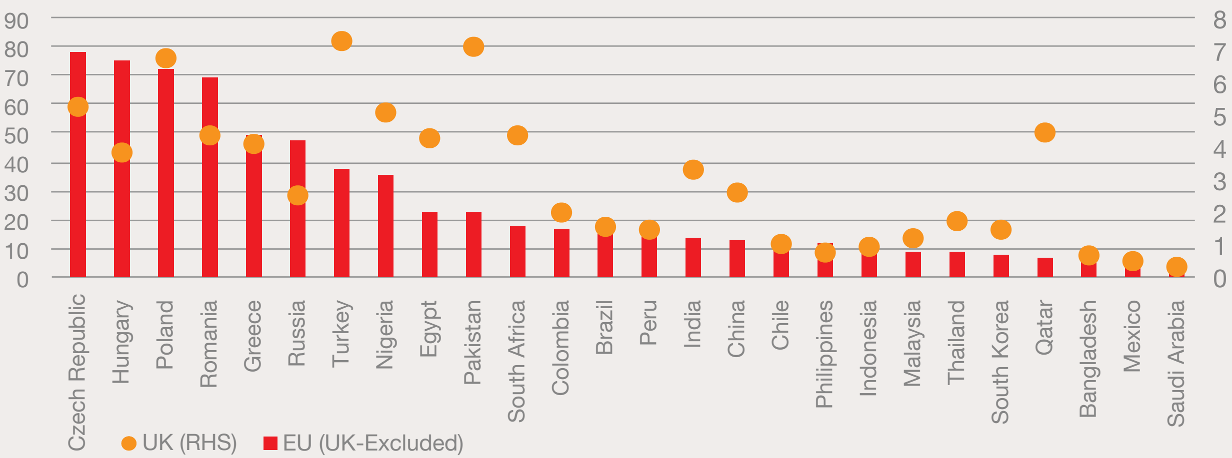
The indirect effect comes into play at this juncture. According to Eurostat, the UK is the second biggest country after Germany that the other EU member states export to. Thus, a decline in economic activity in the UK means a reduction of their import from EU member states to this relatively important trade partner. The export share of the EU27 in EMs'total exports, is significantly greater than that of the UK. The average EU27 share in emerging countries' total export is 27%, where the top three countries with the biggest EU exposures are the Czech Republic, Hungary and Poland. This further explains the ranking of stock market declines shown in the previous section.

On the other hand, the cost of imports from the UK will decline for emerging countries, as the pound has lost value. However, this might be offset by price hikes by UK exporters in order to compensate for higher import prices on their side.

In the long-run, the effects will again depend on the agreements made in the exit negotiations. In case of a smooth exit and good trade terms between the UK and the EU, this will be beneficial worldwide. However, if negotiations result in a so called 'hard' Brexit, the effects (both direct and indirect) on trade may be considerable.

Countries that have an advantageous geographical and political position may be able to manage an adverse Brexit scenario by diversifying their trading partners, client base and product range. As an example of such diversification, in 2011, almost 50% of all Turkey's exports were going to the EU. However, the Eurozone crisis led to a downturn in 2012 in demand from Europe, and since then Turkey's exports to Europe have declined to a share of only 35%. In the

Chart 4 EU27 and UK shares in emerging countries' export (in %)



Source: World Bank World Integrated Trade Solutions, UN Trademap, Countries' Statistical Offices, and PwC Turkey

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years since 2012, Turkey has compensated for this by finding new markets in the Middle East, as well as diversifying its range of exports.

Foreign Direct Investments (FDI)

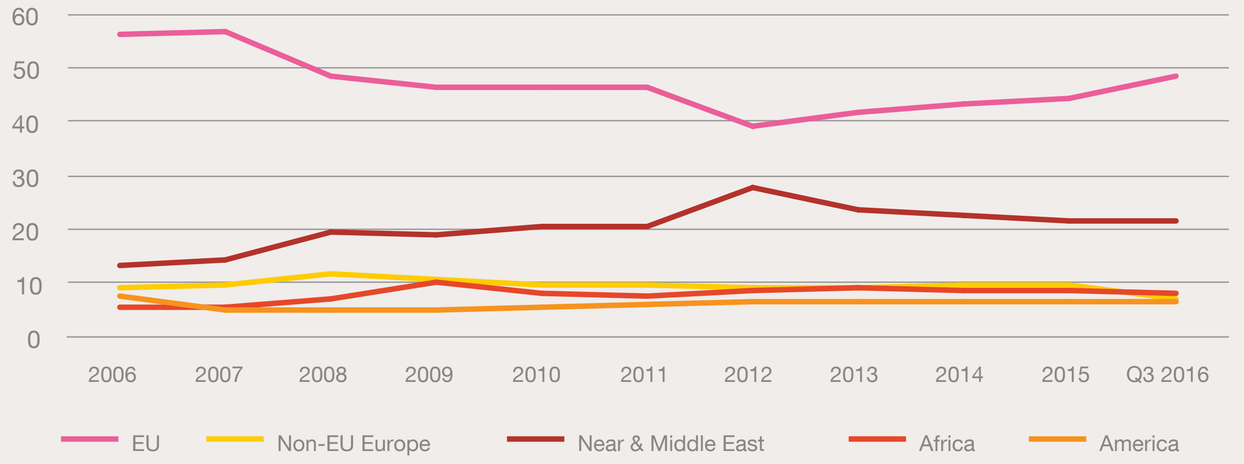
The UK's total stock of inward investment has grown steadily over time since its accession to the EU, amounting to around £1 trillion in 2014.[3] The UK could face an increase in tariffs and/or non-tariff barriers to trade with the EU following the exit from the EU, depending on the nature of the post-exit agreement with the EU. An increase in trade barriers would likely have a knock-on impact on investment and in particular FDI, as EU market restrictions may lower the returns on investment in the UK. For now, some investors refrain from investing in the UK until the future relationship between the EU and the UK will become clearer. The situation will be much the same for the UK investors who had plans to invest abroad.

Because of uncertainties surrounding investments in the UK, Brexit may provide an opportunity for emerging markets to attract inflows. According to the United Nations Conference on Trade and Development (UNCTAD's) 2016 World Investment Report, eight of the top twenty host countries for FDI, are developing or transition economies.[4] For European investors, EU member EMs may become a likely destination for investments instead of the UK if the UK exits the Single Market. Currently, 22% of the EU direct investment stocks are go to non-EU emerging countries. If we add emerging EU members, the EM share goes up to 25%. The total of FDI that goes to the UK, is more than half of the outward investments to emerging countries. As such, relocation decisions of EU based companies, offer opportunities for emerging markets in the EU.

Looking at the UK's outward international investment position (outward FDI stock values), EMs receive 10% of those investments, while the EU27 received 40%.[5] UNCTAD's World Investment Report also shows that the UK is the top six investor in emerging countries. If the UK leaves the Single Market, investments that were previously destined for emerging markets in the EU, may be redirected to non-EU emerging markets. There is also room for overall growth in UK investments in EM's, which could add to the positive effects for those markets.

All in all, EM policy makers should try to make the most of this transition process by implementing structural reforms, and launching new incentives to attract both EU27 and UK FDI post Brexit.

Chart 5 Turkey's export by destination (in % of total export)



Source: Turkstat, PwC Turkey.

3 PwC (2016), "Leaving the EU: Implications for the UK economy"
4 United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2016
5 The Office for National Statistics (ONS)

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Funding

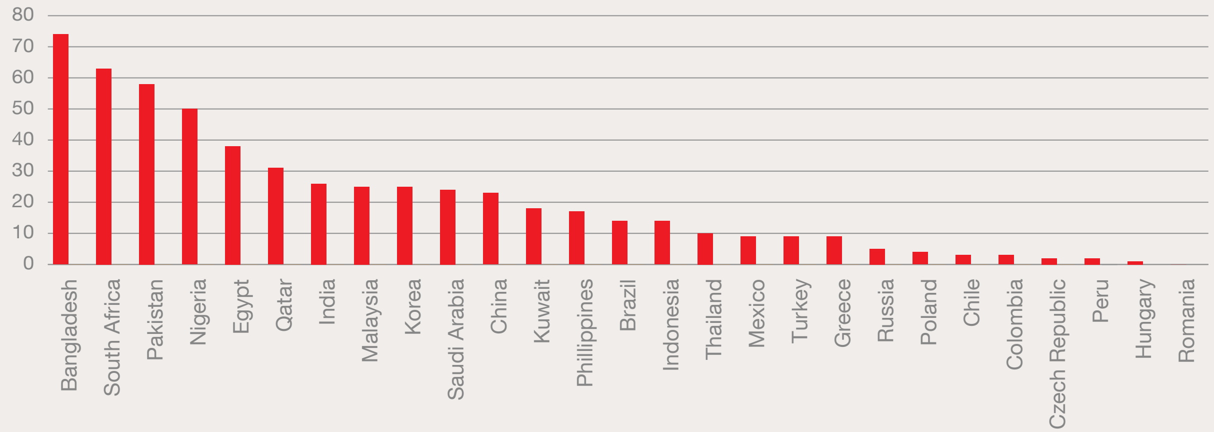
EMs that are already EU members, are benefitting significantly from the EU's structural funds. As the UK is a net contributor to the EU budget, once the UK leaves the amount of funding available will decrease. As the average share of EU funding in EU member EMs' GDP (Hungary, Poland, Romania, Czech Republic and Greece) is around 20%, the loss will be significant for those countries and the shortfall in funding is a matter that the EU needs to address.

Funding also matters in terms of external borrowing and UK banks' operations in EMs. UK banks have a significant share in the funding structure in many emerging markets through EMs secure syndicated loan structures. According to BIS[6] data, Asian and African EMs have a higher risk exposure to the UK in this respect. According to the City of London's Emerging Markets Quarterly Outlook in July 2016, UK banks have sizeable operations in emerging markets, most notably in Asia, where they supply over 30% of all lending. In contrast, the UK's share in total foreign claims (on ultimate risk basis) in European and Latin American EMs is low, at 5% on average.

Pending the exit negotiations between the EU and the UK, conclusions about funding remain uncertain. Uncertainty or volatility in the UK's financial services sector may lower the flow of credit to EMs, and may especially affect those countries that have a higher UK (risk) exposure and a higher external funding need (higher current account deficit, for instance). Last but not least, remittances, i.e. money transfers between private persons, are important in terms of financial flows to EMs. According to World Bank data Poland, Hungary and the Czech Republic are all in the top ten list of countries receiving remittances from the UK. Although the amount is not significant in relation to GDP, remittances will be affected by a weaker pound sterling. However, for EMs within the EU, labour mobility will be a more important issue in terms of financial flows from the UK as it affects an individual's opportunity to gain employment in the UK. Indeed, as stressed in earlier Monitors, the mobility of workers will be a key issue for all sides in the upcoming negotiations.

6 Bank for International Settlements

Chart 6 UK's share in total foreign claims on ultimate risk basis, Q2 2016



Source: Bank for International Settlements, PwC Turkey.

Top 10 remittance receiving countries from the UK

	Amount of Remittance ($, million)	Share in UK's worldwide remittance	Amount of Remittance / GDP
India	*3.895*	*15,4%*	*0,2%*
Nigeria	3.700	14,6%	0,7%
Pakistan	1.644	6,5%	0,7%
Poland	1.144	4,5%	0,2%
China	974	3,8%	0,0%
Philippines	567	2,2%	0,2%
Bangladesh	537	2,1%	0,3%
Hungary	358	1,4%	0,3%
South Africa	220	0,9%	0,1%
Czech Republic	209	0,8%	0,1%

Source: Bank for International Settlements, PwC Turkey.

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The Takeaway

The UK's vote to leave the EU is not expected to have a significant direct impact on emerging markets in macro-economic terms. However, the UK is an important trading partner, a source of investments and provider of funding for many emerging markets. Furthermore, the indirect effects from lower economic growth in the EU following Brexit, may have broader effects on emerging markets.

However, Brexit also creates an opportunity for EMs, as it presents an opportunity for structural reforms that could strengthen the competitiveness of those economies. This would require bold action by EM authorities, fiscal discipline and an ability to manage financial market volatility.

In light of this, corporates should effectively adapt their strategies to the new status quo after the UK leaves the EU. A starting point would be their financial market exposure. EM companies that are exposed to higher market risk should use risk management tools and hedge against Brexit related risks. In terms of trade, firms would do well exploring new opportunities to diversify their trade both in terms of products, as well as end markets. In order to attract FDI, companies must increase their lobby activities to convince governments to incentivise inward investments. And for funding, companies that are dependent on external borrowing should consider changing their financing structure to minimise their Brexit related external exposure.

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