The impact of Brexit

August 2016

national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

The immediate financial market reaction to Brexit was negative

- Markets were pricing in "remain" vote
- The pound and euro have weakened
  - Concerns about further break up in Europe
  - Questions as to how the BoE will respond
- Expectations of weaker growth, lower risk appetite and central bank support to markets has resulted in bond yields in developed economies falling

	22/06/2016 (5pm)	23/06/2016 (5pm)	24/06/2016 (6 am)	24/06/2016 (5pm)	Change since Thursday night	
US dollars per British Pound	1.4686	1.4807	1.3528	1.3635	-7.9%	Pound weakness - percentage change
SA rands per British Pound	21.545	21.419	20.955	20.293	-5.3%	Pound weakness - percentage change
US dollars per Euro	1.1283	1.1351	1.0998	1.1117	-2.1%	Euro weakness - percentage change

	22/06/2016 (5pm)	23/06/2016 (5pm)	24/06/2016 (9 am)	24/06/2016 (5pm)	Change since Thursday night	
UK 10 year bond yields	1.308	1.36	1.017	1.1	-0.26	Percentage point drop in UK yields
US 10 year bond yields	1.7042	1.7181	1.4851	1.565	-0.15	Percentage point drop in US yields
German 10 year bond yields	0.067	0.076	-0.1089	-0.064	-0.14	Percentage point drop in German yields

Source: Bloomberg

UK Treasury estimates "Brexit" could lower the UK's GDP level by between 3.8 per cent and 7.5 per cent
- 'financial conditions effect' on financial market volatility
- 'uncertainty effect' on investment, trade
- 'transition effect' as UK becomes less open to trade & investment

Emerging markets suffered too

- Risk appetite worsened
  - EM bond spreads have widened
  - EM currencies have weakened

- Safe haven assets like gold, dollar have strengthened

- Other commodities and EM assets have declined as fears of weaker growth have affected valuations

	22/06/2016 (5pm)	23/06/2016 (5pm)	24/06/2016 (6 am)	24/06/2016 (5pm)	Change since Thursday night	
Gold price (US$ per troy ounce)	1267.63	1262.97	1330.05	1313.55	4.0%	Gold strength - percentage change
Oil price (US$ per barrel)	50.33	50.14	47.98	48.56	-3.2%	Oil weakness - percentage change

	22/06/2016 (5pm)	23/06/2016 (5pm)	24/06/2016 (9 am)	24/06/2016 (5pm)	Change since Thursday night	
SA 5 year CDS	2.88	2.8	3.03	2.93	0.13	Percentage point rise in SA CDS
Brazil 5 year CDS	3.23	3.23	3.31	3.35	0.12	Percentage point rise in Brazil CDS
Turkey 5 year CDS	2.47	2.4	2.61	2.59	0.19	Percentage point rise in Turkey CDS

Source: Bloomberg

But since then, markets have calmed substantially

- Both in developed and developing financial markets

	22/06/2016 (5pm)	23/06/2016 (5pm)	24/06/2016 (5pm)	03/08/2016	% chg
US dollars per British Pound	1.4686	1.4807	1.3635	1.3328	-2.3%
SA rands per British Pound	21.545	21.419	20.293	18.505	-8.8%
US dollars per Euro	1.1283	1.1351	1.1117	1.11	-0.2%

	22/06/2016 (5pm)	23/06/2016 (5pm)	24/06/2016 (5pm)	03/08/2016	% chg
UK 10 year bond yields	1.308	1.36	1.1	0.805	-0.30
US 10 year bond yields	1.7042	1.7181	1.565	1.54	-0.02
German 10 year bond yields	0.067	0.076	-0.064	-0.038	0.03

	22/06/2016 (5pm)	23/06/2016 (5pm)	24/06/2016 (5pm)	03/08/2016	% chg
Gold price (US$ per troy ounce)	1267.63	1262.97	1313.55	1363.13	3.8%
Oil price (US$ per barrel)	50.33	50.14	48.56	43.62	-10.2%

Thanks to supportive policy responses

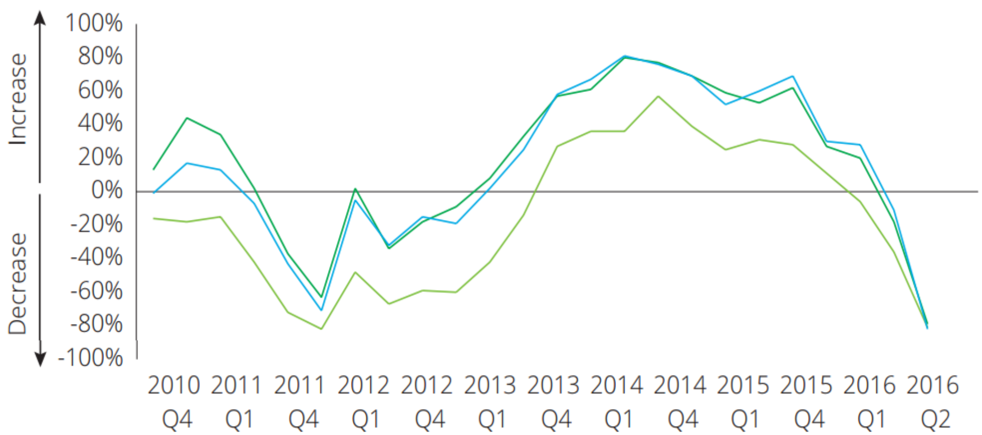
- Expectations are that there will be sufficient support from central banks
  - BoE expected to cut by 0.25% points today (99.8% expectation)
    - And there is an 25 per cent probability that rates will be zero by December
  - The ECB expected to remain on hold, but ready to act
    - Probability of a cut in August is about 25%, rising to 40% by December
  - There has been a sharp downward revision to Fed rate hike expectations
    - On 3rd August, 39% probability of rate hike by December 2016 (59% on 3rd June)

- And the UK government has hinted that it may have to use stimulus to support the economy
  - Total public borrowing in 2015/16 £75 bn (4 per cent GDP).
  - Due to fall to £55.5 bn 2016/17 and £38.8 bn 2017/18
  - But some forecast may rise as much as £65billion based on past studies

Confidence measures have broadly fallen

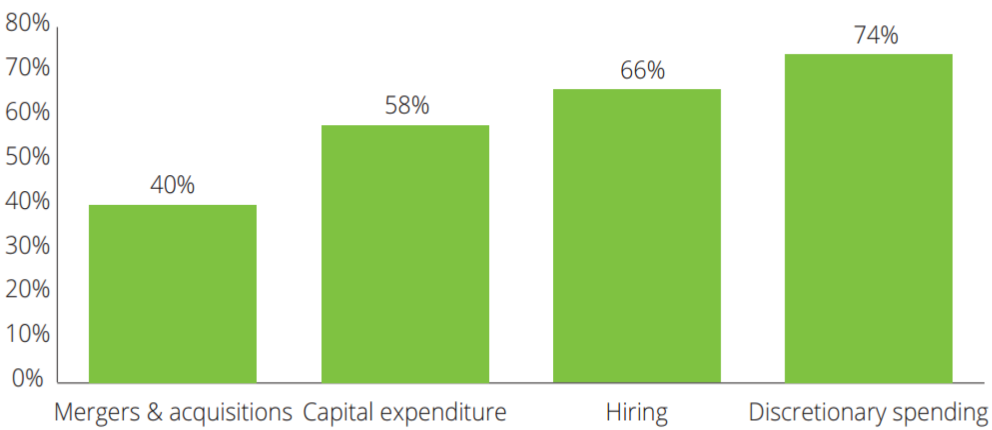
Outlook for capital expenditure, hiring and discretionary spending

Net % of CFOs who expect UK corporates' capital expenditure, hiring and discretionary spending to increase over the next 12 months



Effect of Brexit on investment plans decisions

% of CFOs who expect M&A activity, capital expenditure, hiring and discretionary spending by their business to decrease over the next three years as a consequence of Brexit



The National Institute of Economic and Social Research says growth has 50 / 50 chance of technic recession

The CBI survey of SME manufacturers says business optimism has fallen at its fastest rate since January 2009 and are scaling back investment plans – although production and employment is higher, and higher export projections

The Markit/CIPS manufacturing purchasing managers' indexsuggested that activity among UK manufacturers in July had shrunk at its fastest pace for three years

https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/finance/deloitte-uk-finance-cfo-survey-q2-2016.pdf

The truth is there is still huge uncertainty

- Will it actually happen?
  - May has told the House of Lords they must respect the referendum results
  - But Labour will consider 2nd referendum on EU membership, LibDems will fight the next general election on a manifesto promising to take the UK back into the bloc

- When will Article 50 deals be triggered?
  - May has said this will happen early next year
  - Sky Bet seems to think that "early 2017" is about Q2
  - Concerns about EU 21 January 2019 budgeting cycle

July 1 to September 20 2016— 33/1
October 1 to December 31 2016 — 9/1
January 1 to March 31 2017 — 9/4
April 1 to June 30 2017— 3/1
July 1 to September 30 2017 — 7/1
2018 or later or not at all — 6/4

- Nature of deals
  - May not keen for off-the-shelf negotiations – but unclear if this will be extended to other countries – could mean significantly protracted discussions
  - Biggest countries likely to support a deals
  - But EU need to incentivise people to remain..
    - New negotiator from European Commission a sign?
  - Liam Fox: UK might leave the EU customs union to facilitate trade deals with other countries
  - EU officials: UK should not expect Brexit to happen before at least 2020

The impact of Brexit

	ST (0 – 6 months)	MT (6 – 18m)	LT (18+ months)
Primary channel	Financial markets	GDP impact of financial market moves – primarily confidence, investment	GDP impact as switch in trade agreements
		Extent depends on how large financial market impact is*	Extent depends on UK, EU, US negotiation tactics
Global impact	• UK, EU asset prices fall • Volatility increases – esp. for those with close links to UK • Commodity prices fall • ECB, BoE, Fed stimulus	• UK GDP 1.5 percentage points lower than baseline by 2018^ • EU GDP around 1 per cent lower by 2018 (OECD)	• UK growth • Lowest impact on those who have been able to re-negotiate positions
	Extent depends on response to central bank stimulus		Extent depends on priority for UK negotiators
EM impact	• Risk appetite declines • Flows to EMs fall • EM fx weakens • EM vol increases	• BRICS and other non-OECD economies 0.5 percentage points lower by 2018 due to weaker EU growth (OECD)	• Trade may be negatively affected
SA Policy implications	• Issuance costs increase • Risk of unfulfilled auctions • Risk to bank financing • Gold, oil vs export metals	• Lower SA growth • Lower confidence • Heightened risk of ratings downgrade	• EU-EPA and preferential trade affected • UK investment treaties

^ Two thirds of shock due to financial market shocks; the remaining third due to feedback effect of weaker EU growth
* OECD assumes relatively high financial shocks to EU from Brexit (between 20 and 50% of size of UK shock)

Source: dti, SARB

SA’s links with the UK are substantial

Trade

- 6^{th} largest trading partner
- In 2015, SA exported R41.6 billion worth of products into the UK and imported R35 billion with a R6.6 billion trade balance in favour of SA
- UK makes up about 4% total exports
  - 43% in platinum
  - 8% commercial cars
  - 4% each for centrifuges and passenger cars
  - 4% each for wine, grapes, citrus, deciduous fruits

Investment

- UK accounts R1.8 trillion of SA’s R4.9 trillion foreign investment stock in 2014 (37%).
- 42 % portfolio investment (mostly equities)
- 40% direct investment
- 18% “other” investment (mostly deposits to SA banks)

Tourism

- Around 17% of overseas tourists from UK

Source: dti, SARB

Brexit raises deep socio economic and political concerns

KEY TRENDS HIGHLIGHTED BY BREXIT

- Rise of far-right, anti-immigration, anti-establishment politicians, anti-globalisation sentiment
  - Is a new type of globalisation required?
  - Do Africa and Asia have to re-think their economic growth models?
- Deglobalisation
  - Banking sector requires controls on international flows for stability
- Secular stagnation likely to be compounded
  - Uncertainty, changes to trade patterns
- Could affect global composition of power

In SSA there is still a strong need for integration.
Do we need to reconsider?

IMPLICATIONS FOR SA

- Could reduce momentum in terms of local politics and will to reform
- Could build up momentum domestically for xenophobia, radical domestic politics
- Potential to re-position SA as a high-yield investment in world of global uncertainty
- Banking system needs to be able to manage the flow of capital to ensure stability
- Need to expand relationships with more open export partners

South Africa's strategy to manage impact of Brexit

- Minimise potential impact of financial instability on South Africa
  - Manage risks to fiscal framework and the concomitant risks to debt issuance
- Monitor financial market conditions and impact on stability
  - SARB and National Treasury constantly monitor

- Trade agreements, investment treaty – monitor the shifts in UK negotiating strategy.
  - dti managing process

- Continue to pursue growth strategy
  - South Africa needs to generate internal sources of growth
  - Increased coordination between government and business
    - Sector interventions on agriculture and tourism
    - SME fund
    - SOC reforms

- Continue to position South Africa as strong, profitable investment destination
  - Brexit highlights concerns of secular stagnation, deglobalisation, particularly in older economies

What does longer term impact mean for SA?

TRADE AGREEMENTS

- Timing of exit from existing agreements will depend on date at which Article 50 is triggered
- UK could switch to European Free Trade Association (EFTA)
  - Could happen quite quickly since a lot of overlap with existing agreements
  - Would need to have agreement on basic agricultural products, as currently negotiated on case-by-case basis.
  - Would also need to consider negotiating additional market access for some agricultural products agreed to under EU-SADC EPA which are not part of the EFTA.
- UK could prefer to negotiate bilaterals
  - Likely to entail protracted negotiation process

INVESTMENT AGREEMENTS

- Investment promotion and protection act will cover UK investors

TOURISM / VISA AGREEMENTS

- Already separate systems, so impact likely to be limited

Critical to negotiate trade & investment treaties sooner rather than later

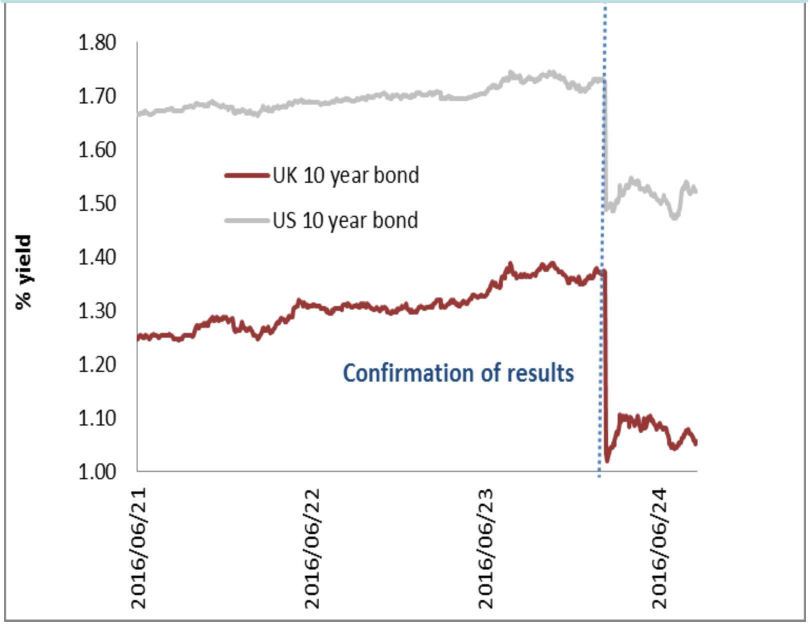
- SA is largest African trading partner
- But Africa is a very small part of the UK trade

- QUESTIONS?

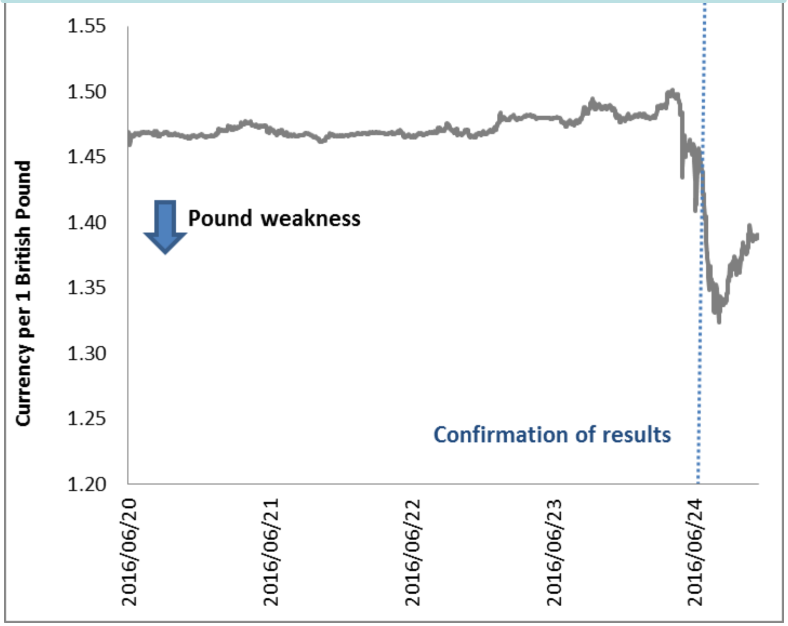
ANNEX

Financial markets - Developed market reactions to Brexit

Intraday trading in UK, US bonds



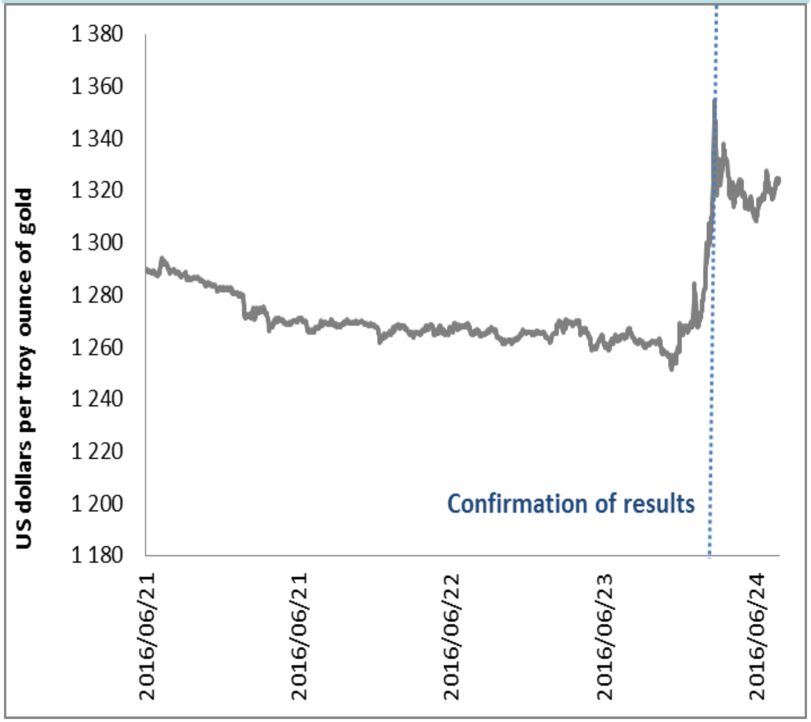
Intraday trading in pound



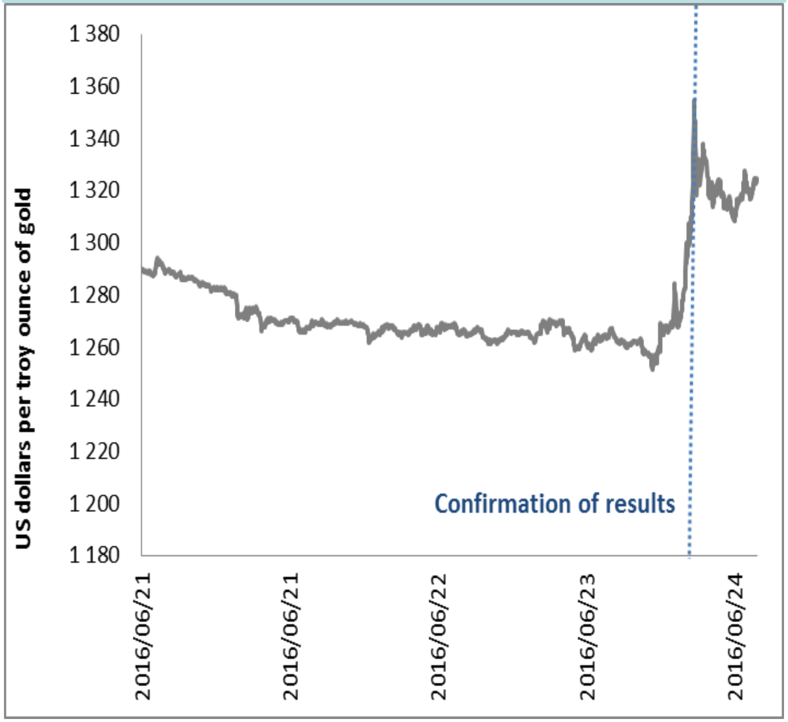
Source: Bloomberg

Financial markets - Commodity market reactions to Brexit

Intraday trading in Gold



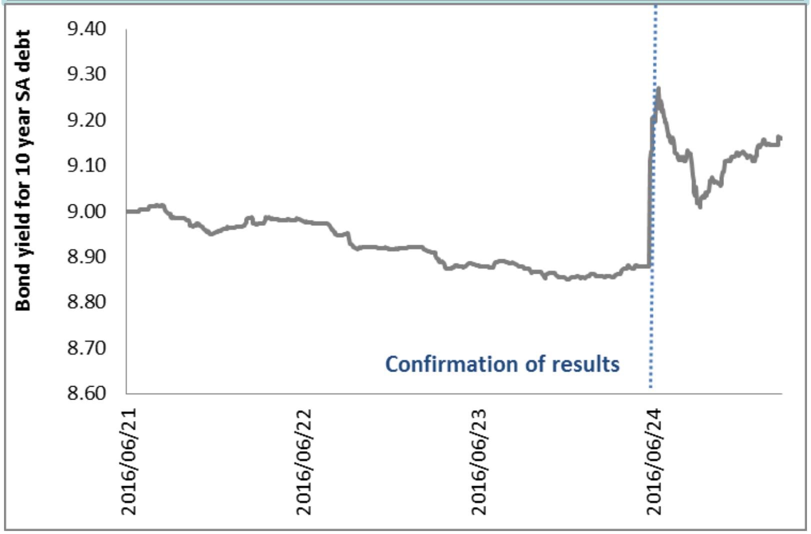
Intraday trading in oil



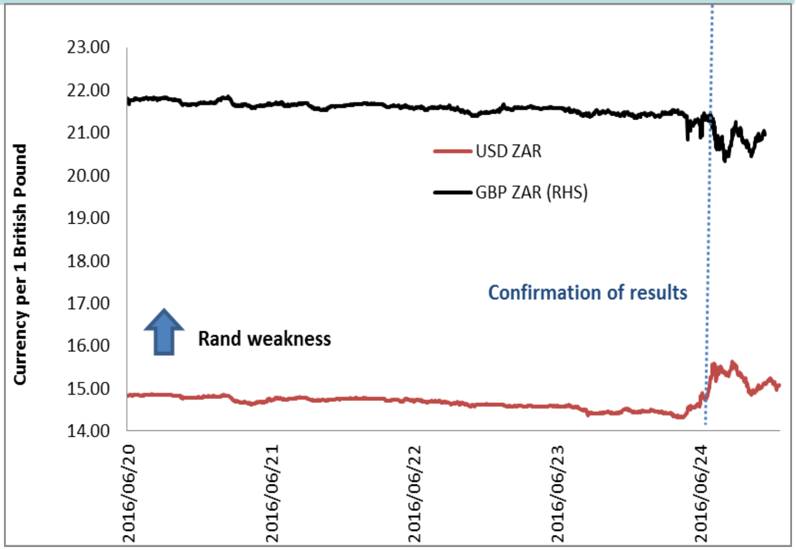
Source: Bloomberg

Financial markets - EM market reactions

Intraday trading in SA 10 year bonds

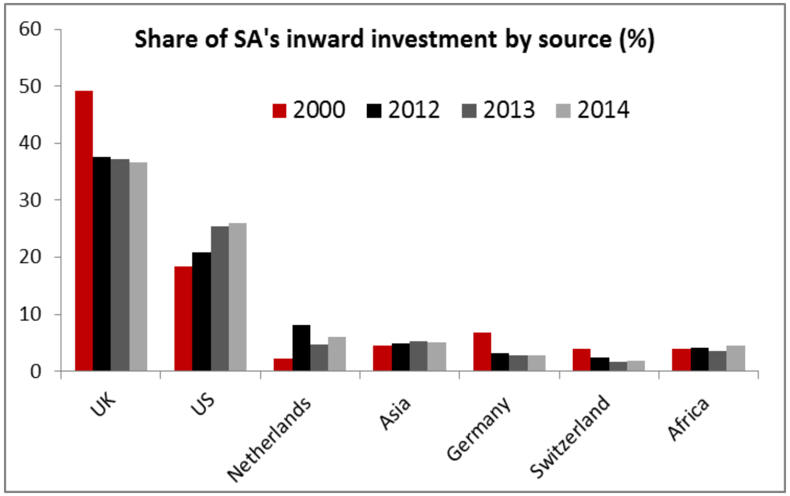


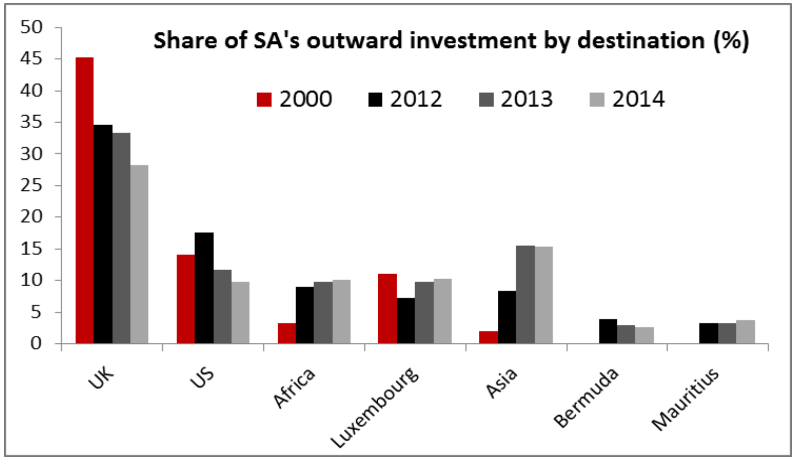
Intraday trading in Rand



Source: Bloomberg

Stock of investment between SA and UK





Source: SARB

Inward investment from the UK

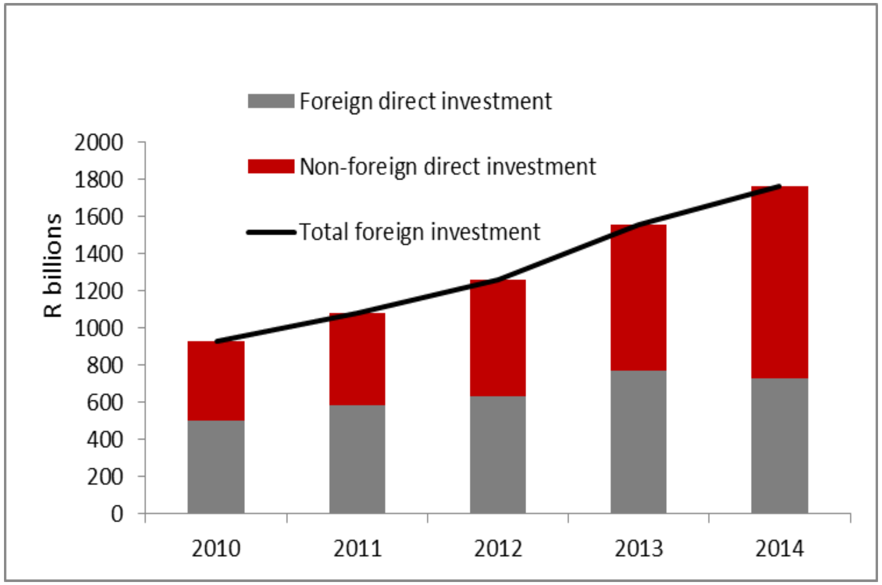
- The UK is the largest investor in SA, accounting for 37% of total foreign investment stock in SA in 2014. Held R1.8 trillion of SA's R4.9 trillion foreign investment stock.
- However, its share has gradually declined over the years due to faster investment growth from other regions (Asia, Asia, Americas).
- Portfolio investment (mostly equities) makes up 42% of total UK investment in SA while direct investment accounts for 40% and "other" investment the remaining 18%.

SA investment to UK

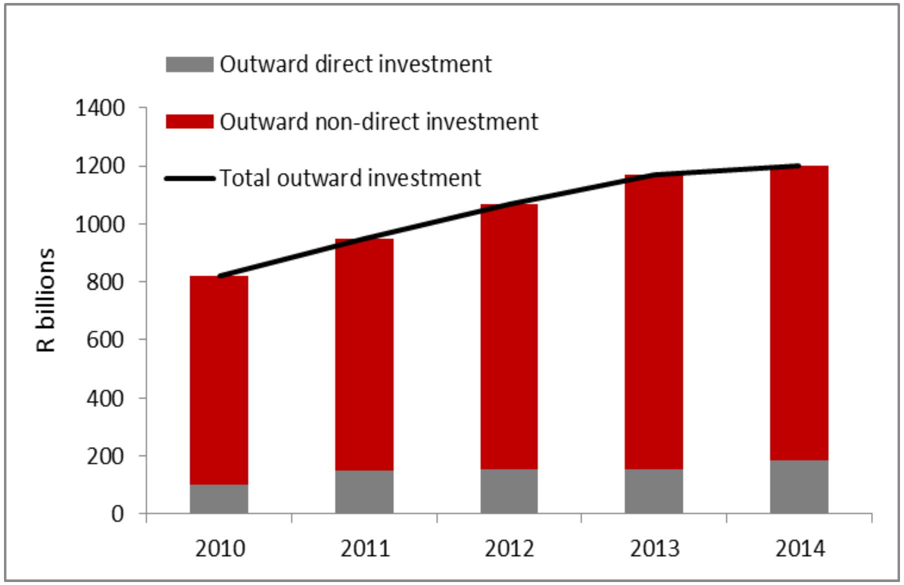
- The UK is the largest recipient of SA's investment, accounting for 29% SA's total outward investment stock in 2014. Holds R1.2 trillion of SA's R4.3 trillion outward investment stock.
- Nonetheless, SA's increased investment in Asia and the rest of the African continent has seen UK's share of total outward investment decline from around 45% in 2000.
- SA's investments are mainly in portfolio investments (60%), while direct investment and other investment account for 14% and 26%, respectively.

Stock of investment between SA and UK

Foreign investment from UK



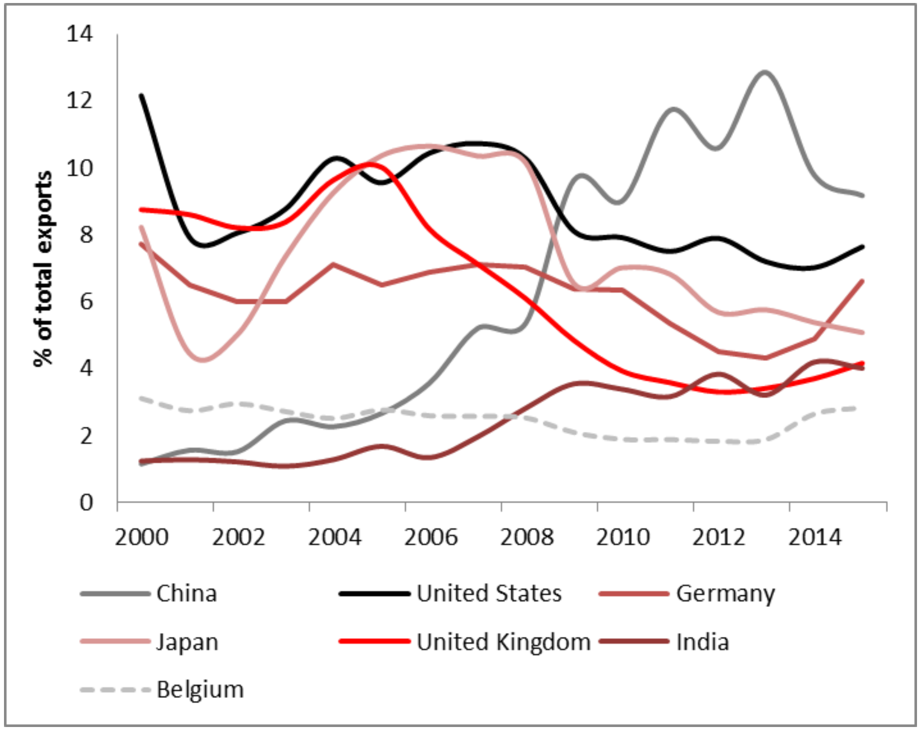
SA investment to UK



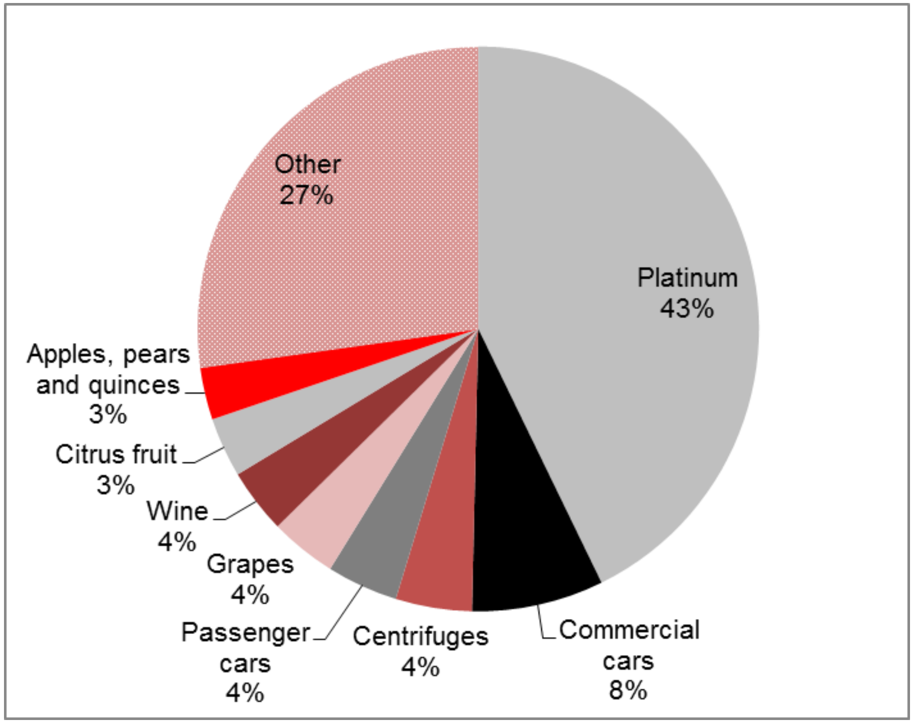
Source: SARB

Trade composition

Export shares by country



Composition of exports to the UK - 2015

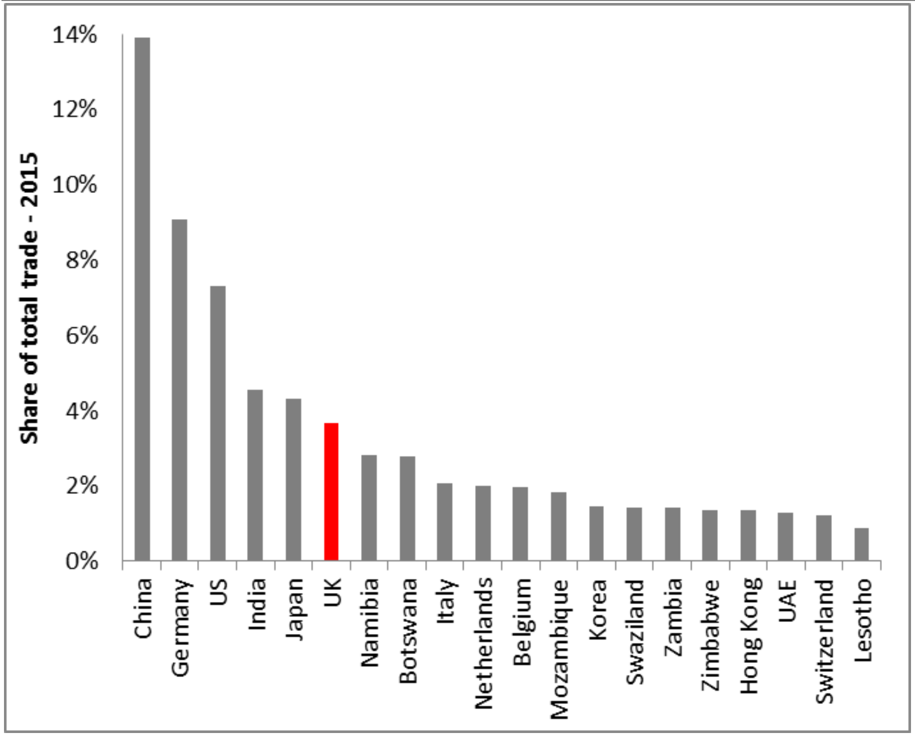


- While the UK is no longer top recipient of South African exports it remains a top 10 export destination
- 8 export products comprise 72,8% of SA's total exports to the UK

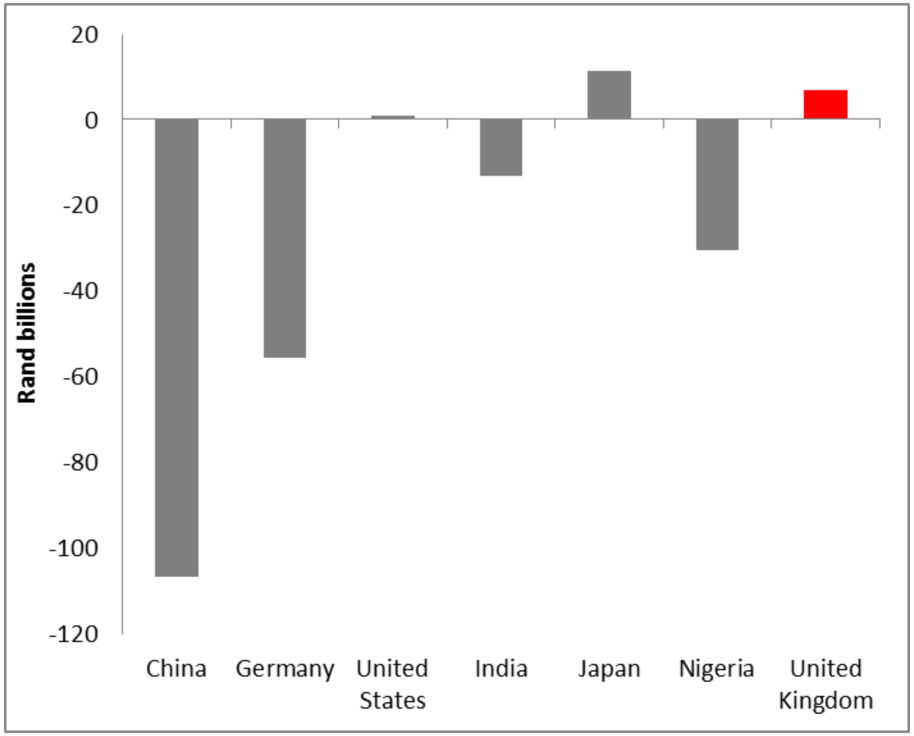
Sources: Quantec, National Treasury calculations

Trade composition (cont.)

Total trade - 2015



Trade balance



- Regarding total trade (i.e. both imports and exports), the UK ranked 6th largest trading partner
- In 2015, SA exported R41.6 billion worth of products into the UK and imported R35 billion with a R6.6 billion trade balance in favour of SA

Sources: Quantec, National Treasury calculations