The impact of Brexit

June 2016
The immediate financial market reaction to Brexit has been 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

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<th>22/06/2016 (5pm)</th>
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<th>24/06/2016 (6 am)</th>
<th>24/06/2016 (5pm)</th>
<th>Change since Thursday night</th>
</tr>
</thead>
<tbody>
<tr>
<td>US dollars per British Pound</td>
<td>1.4686</td>
<td>1.4807</td>
<td>1.3528</td>
<td>1.3635</td>
<td>-7.9% Pound weakness - percentage change</td>
</tr>
<tr>
<td>SA rands per British Pound</td>
<td>21.545</td>
<td>21.419</td>
<td>20.955</td>
<td>20.293</td>
<td>-5.3% Pound weakness - percentage change</td>
</tr>
<tr>
<td>US dollars per Euro</td>
<td>1.1283</td>
<td>1.1351</td>
<td>1.0998</td>
<td>1.1117</td>
<td>-2.1% Euro weakness - percentage change</td>
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<tr>
<td>UK 10 year bond yields</td>
<td>1.308</td>
<td>1.36</td>
<td>1.017</td>
<td>1.1</td>
<td>-0.26 Percentage point drop in UK yields</td>
</tr>
<tr>
<td>US 10 year bond yields</td>
<td>1.7042</td>
<td>1.7181</td>
<td>1.4851</td>
<td>1.565</td>
<td>-0.15 Percentage point drop in US yields</td>
</tr>
<tr>
<td>German 10 year bond yields</td>
<td>0.067</td>
<td>0.076</td>
<td>-0.1089</td>
<td>-0.064</td>
<td>-0.14 Percentage point drop in German yields</td>
</tr>
</tbody>
</table>

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 have suffered too

- Critically for EMs, risk appetite has 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

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<tr>
<td>Gold price (US$ per troy ounce)</td>
<td>1267.63</td>
<td>1262.97</td>
<td>1330.05</td>
<td>1313.55</td>
<td>4.0% Gold strength - percentage change</td>
</tr>
<tr>
<td>Oil price (US$ per barrel)</td>
<td>50.33</td>
<td>50.14</td>
<td>47.98</td>
<td>48.56</td>
<td>-3.2% Oil weakness - percentage change</td>
</tr>
<tr>
<td>SA 5 year CDS</td>
<td>2.88</td>
<td>2.8</td>
<td>3.03</td>
<td>2.93</td>
<td>0.13 Percentage point rise in SA CDS</td>
</tr>
<tr>
<td>Brazil 5 year CDS</td>
<td>3.23</td>
<td>3.23</td>
<td>3.31</td>
<td>3.35</td>
<td>0.12 Percentage point rise in Brazil CDS</td>
</tr>
<tr>
<td>Turkey 5 year CDS</td>
<td>2.47</td>
<td>2.4</td>
<td>2.61</td>
<td>2.59</td>
<td>0.19 Percentage point rise in Turkey CDS</td>
</tr>
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Source: Bloomberg
## The impact of Brexit

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

TRADE AGREEMENTS

• Existing agreements will be exited by 2019
• 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

• Still to be determined

TOURISM / VISA AGREEMENTS

• Already separate systems, so impact likely to be limited

Source: dti
What next?

MARKETS
• Markets were surprised – so negative sentiment likely to be sustained for some time
• BoE, ECB expected to respond with sufficient liquidity to keep financial market stresses limited.
• There are likely to be significant efforts to ensure smooth transition for financial markets in UK
• Cameron and Osborne likely to be replaced in next 3 months, which could generate uncertainty over UK fiscal outlook
• There may be increased chatter for further EU disintegration – and heightened EU risk premia

POLICY
• Will need time before get details on how UK will be approaching trade and investment treaties
• The response of other trading partners could affect risk of further EU break up
  – EU have already adopted an aggressive stance (want UK out ASAP)
  – Not clear whether US will follow suit on threats
• This could have implications for EM, SA negotiations

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
ANNEX
Financial markets - Developed market reactions to Brexit

Intraday trading in UK, US bonds

- % yield
- UK 10 year bond
- US 10 year bond

Intraday trading in pound

- Currency per 1 British Pound
- Pound weakness

Source: Bloomberg
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
**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
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
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