Box B: Brexit: Latest Indicators and Possible Implications for the Irish Economy

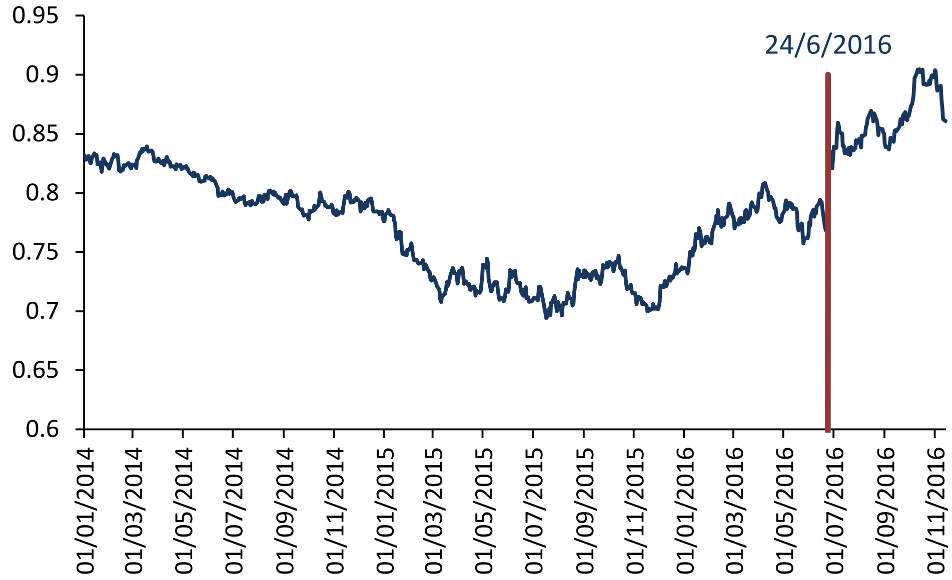
The UK vote to leave the EU is set to have a significant impact on the Irish economy given the extent of the trade links between Ireland and the UK. While the longer term issues surrounding the terms of a UK exit from the EU will remain unknown for some time, this Box collates some of the early indications of the impact of Brexit on the UK and Irish economies. The Box draws on analysis of the potential impact of Brexit on the Irish economy published in the Council's September 2016 *Pre-Budget Statement*.

It will take some time to accurately see the impact the vote to leave the EU has on the UK economy; however some early indicators of the short run impacts are available. The most recent quarterly data from the Office of National Statistics (ONS) show that growth slowed in the third quarter of this year, from 0.7 per cent to 0.5 per cent. Growth was entirely driven by the services sector, with the other three sectors (construction, agriculture and production) all registering declines. While there is no evidence of significant immediate falls in GDP, the main effects of Brexit are expected to take hold from 2017 and beyond. The significant depreciation of Sterling is cushioning the fall in UK output, at least in the short term.

The most obvious and immediate impact of Brexit on the Irish economy has come via exchange rates. There was some weakening of Sterling in the first half of this year in advance of the referendum. This was followed by a 6 per cent fall the day after the referendum and there have been significant falls since, particularly after the UK Prime Minister announced that Article 50 would be invoked by the end of March 2017 (Figure B1). The current rate implies an almost 20 per cent appreciation of the Euro against Sterling compared to the average value in 2015.[1] If the exchange rate were to stay near this level for a prolonged period, this would imply a significant competitiveness loss for Irish firms. Keeping all other factors constant, it would be expected that Irish imports rise and exports fall as a result of these exchange rate movements. Future changes in the exchange rate are difficult to forecast, although it seems likely that the exchange rate will be significantly more volatile over the next couple of years as negotiations over the terms of Brexit take place. In addition to the competitiveness difficulties caused for Irish firms, a more volatile exchange rate will also be problematic for Irish firms.

[1] The current rate is taken at 15 November 2016.

FIGURE B1: UK (£) TO EURO(€) EXCHANGE RATE



Source: Datastream.

Prior to the referendum, forecasting agencies had warned that the growth prospects of the UK would deteriorate significantly if it were to leave the EU. Recent forecasts have reaffirmed this, with the IMF (2016) cutting its forecast of growth in 2017 by more than a percentage point, with reductions between 0.5pp and 0.2pp thereafter out to 2021. Cumulatively, these revisions would imply UK economic output being 2.5 per cent lower than previously forecast. Significantly for the Irish economy, the forecast growth in imports of goods and services was revised down to a much greater extent than the forecast for overall GDP, with imports into the UK in 2021 forecast to be 11 per cent lower than was forecast in April 2016. Most of this downward revision comes in 2017. Given that 17 per cent of Irish exports go to the UK, this reduced demand for imports into the UK, combined with a less favourable exchange rate would have a significant impact on the Irish economy.

While the central forecast scenarios of agencies such as the IMF and Bank of England are a useful guide as to what the potential impacts of Brexit could be, the ultimate effect is uncertain and hence alternative scenarios are considered. The Council previously presented (IFAC 2016b) two scenarios illustrating the potential impact of Brexit on the Irish economy. The first scenario (Baseline) considered the short-run impact of subdued demand from the UK, exchange rate effects and uncertainty on the Irish economy. These factors combined would see growth reduced by 0.7 percentage points in 2017 and 0.3 percentage points in 2018. As discussed above, compared to *SPU 2016* forecasts, the Department of Finance revised down growth in *Budget 2017* by a similar magnitude for 2017 and 2018.

The Baseline scenario was based on forecasts for the UK economy published by the National Institute for Economic and Social Research in August 2016. The latest NIESR forecasts published in early November 2016 do not contain any major changes to the outlook for 2017 and 2018 compared to the August forecasts and so the Council's Baseline scenario remains unchanged.

Brexit could have significant implications for medium-term growth in the UK economy. The most likely channels through which this would occur would be reduced FDI and trade, both of which would contribute to lower productivity growth. Permanently lower UK output growth would be expected to give rise to persistently lower demand for Irish. In addition, smaller trade flows between Ireland and the UK could reduce potential supply in the Irish economy by lowering aggregate productivity. This would in turn reduce Irish potential growth rates.

Prior to the referendum, HM Treasury (2016) estimated the long run impact of different post-Brexit trade arrangements on the UK economy. The most adverse scenario shown is a WTO arrangement. Under this scenario, UK GDP would be 7.5 per cent lower after 15 years compared to a baseline where the UK remained in the EU. Similarly, NIESR (2016a) show a number of different scenarios for how Brexit could impact the UK economy out to 2030. Similar to the HM Treasury result, the most adverse NIESR scenario (WTO and an associated loss in productivity) has GDP 7.8 per cent lower by 2030 compared to the baseline. Output losses of this magnitude would clearly have a significant impact on Irish growth prospects.

The second scenario presented in the *Pre-Budget Statement* considered an adverse case where Brexit resulted in a persistent reduction in the potential growth rate of the Irish economy of 0.5 percentage points per annum over a ten-year period. While not a forecast, it is possible that such a scenario could come about if the UK opts for a “hard Brexit” outcome along the lines of a WTO arrangement, with particularly adverse effects for the Irish indigenous sector. Chapter 3 includes a discussion of the implications of these macroeconomic impacts on the public finances.

In a recent ESRI working paper, Bergin *et al.* (2016) model the medium- to long-term impacts various Brexit scenarios could have on the Irish economy. The three scenarios used are taken from NIESR: firstly, an EEA arrangement similar to that applying between Norway and the EU; secondly, a free trade agreement along the lines of that between Switzerland and the EU; and finally, a WTO arrangement. In each case, growth in the UK (and other economies which are indirectly affected by Brexit) is lower than would otherwise be the case, leading to lower demand for Irish exports. Each of these scenarios is then used as exogenous inputs into COSMO. In the most severe case presented (WTO), Irish output is 3.8 per cent lower than would otherwise be the case ten years after the UK leaves the EU. This estimate is somewhat more benign than the IFAC adverse scenario presented above. This is mainly because the ESRI scenario is only taking into account the reduced demand for Irish exports, with no formal role for trade disruption in excess of that caused by lower growth externally or for domestic uncertainty effects.