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The economic impact of Brexit on Ireland

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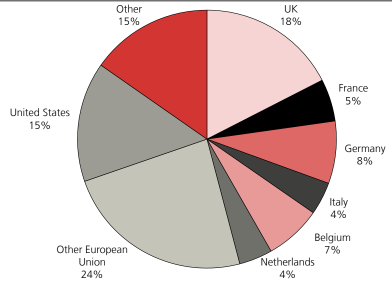
DAVY VIEW

Brexit is now clearly threatening the UK's growth prospects and in the past a 1% reduction in UK GDP has led to a 0.3% fall in Irish GDP. A sharp depreciation of sterling could also hurt Irish exports, though the UK accounts for just 15% of Irish exports, down from 50% in previous decades. While severe trade disruption would only occur in the worst-case Brexit scenarios, the key risk for Ireland is that productivity and trend UK GDP growth are hurt over the long term by an exit from the EU.

Share of Irish exports of goods and services by country



Source: World Trade Organisation

Assessing the economic impact of Brexit on Ireland

Brexit is now clearly threatening the UK's growth prospects. Economic models suggest a 1% reduction in UK GDP reduces Irish GDP by 0.3%. A sharp depreciation in sterling could also hurt Irish exports, as could tariffs, quotas and customs requirements. However, as price-takers, Irish exporters have tended to absorb exchange rate movements into their profit margins in order to maintain output. And the UK now accounts for just 15% of Irish exports, down from 50% in previous decades. Any change to Ireland's common travel area (CTA) with the UK, could also have significant effects on the labour market.

Trade effects would be contained during the exit period

Article 50 of the Lisbon Treaty provides for a two-year exit period, during which there would be no change to trade arrangements. In the event of a Brexit, our view is that an arrangement similar to that with Switzerland is likely, maintaining single market access, albeit with some limited autonomy for the UK on migration. This should limit the impact on Ireland, but it would probably require an extension of the two-year negotiating period.

The worst-case scenario is Brexit without a free-trade agreement. UK manufacturing exports to the EU would be subject to an average 4.6% tariff, with retaliatory measures on Irish and EU exports. Ireland's agri-food sector would be very exposed with 50% of exports still going to the UK, potentially facing intensified competition and subject to non-tariff regulatory barriers and costs. Tourism might also be exposed to changes in the CTA.

Key threat is UK productivity growth suffering over longer term

Estimates of the negative impact of Brexit tend to double or triple if productivity growth is adversely affected. This could be particularly important for Northern Ireland where cross-border trade has grown, and its ability to attract FDI might be hurt by doubts on single market access. Ireland might be able to attract FDI at the expense of the UK but the benefits would likely be small. In summary, Brexit is unlikely to hurt Ireland's recovery markedly in the near term. Instead, it could hurt both Irish and UK GDP growth in the long run as opportunities for efficiency gains are not realised.

Spill-overs from weaker UK GDP growth

According to most estimates, the impact of Brexit on the UK economy would be negative. These estimates suggest that trade barriers could reduce UK GDP by 1-3% in the long run. However, the damage from Brexit doubles or triples to 6-9% of GDP if business investment, productivity growth or competition in the UK economy are hurt by trade barriers.

There are growing signs that uncertainty on Brexit is starting to hurt UK GDP growth.

In the short term, uncertainty surrounding the outcome of the Brexit referendum could persuade UK households and companies to put off spending decisions until after the vote on June 23rd. Indeed, UK consumer and business confidence surveys fell back in January and February and the depreciation of sterling has shown that investors are more reluctant to hold UK assets.

The most worrying sign that this uncertainty is hurting the UK economy is the decline in the services PMI to its weakest level since March 2013. In this context, consensus forecasts for UK GDP growth in 2016 have been revised down sharply from 2.5% to just 2.0% in March.

Table 1: Estimates of the long-run impact of Brexit on the UK economy

Centre for Economic Performance	Trade effects could reduce GDP by 1.3% in optimistic case, 2.6% in pessimistic case.
Open Europe	-1.6% in GDP best case, -2.2% in worst case.
German IFO Institute	GDP per capita between 0.6% and 3.0% lower by 2030; GDP per capita 14% lower if UK fails to negotiate free-trade agreements.
Confederation of British Industry	UK membership of EU worth £62-78bn to UK each year, 3-4% of GDP.
National Institute Economic and Social Research	GDP would be reduced by 2.25% over time if UK left EU.

Source: Davy

Historical estimates suggest that a 1% decline in UK GDP reduces Irish GDP by 0.3%.

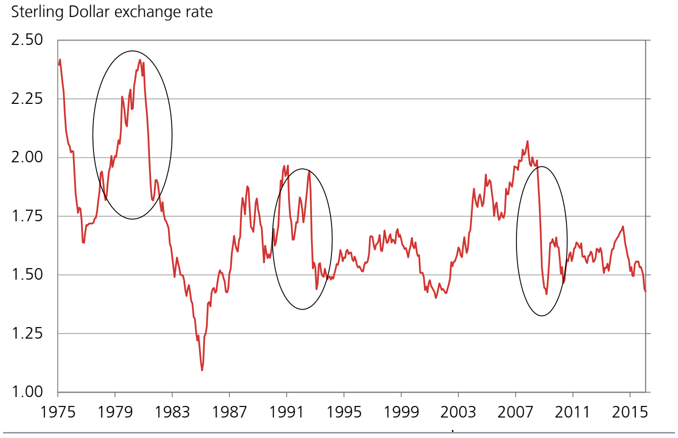
What impact might slower UK GDP growth have on the Irish economy? A recent report by the Economic and Social Research Institute (ESRI) indicates that for each 1% decline in UK GDP, Irish GDP tends to fall by 0.3%. Similarly, Open Europe calculated that Irish GDP would be 1% lower by 2030 in an optimistic scenario and 3% lower in a pessimistic scenario. Some recent studies have found a far higher sensitivity: for example, a recent Centre for Economic Performance (CEP) study found that in an optimistic case UK GDP would fall by 1.3% and Irish GDP by 1%.

However, these estimates are maybe too high. They capture the historic links between the UK and Irish economies which have declined over time. They may also capture the impact of the broader global economic cycle on both the Irish and UK economies in the past, whereas Brexit is a specific event affecting the UK. That said, Brexit may not only be associated with weaker UK GDP growth, but could also have other negative effects on the Irish economy in the areas of trade, migration, the energy market and the outlook for foreign direct investment (FDI), which we discuss below.

Risk of sharp sterling depreciation

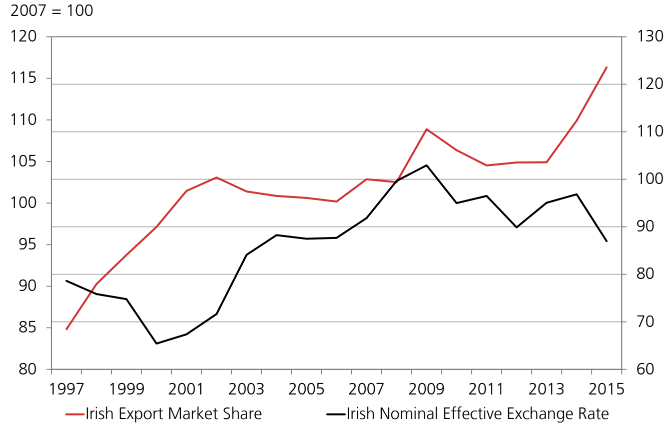
In a recent survey by Bloomberg, the vast majority of economists expected that sterling would fall below $1.35 against the dollar in the event of a vote in favour of Brexit. This would push sterling to its lowest level against the dollar since the mid-1980s. A Brexit vote would certainly push sterling lower against both the dollar and the euro. Figure 1 shows how sterling lost over 25% against the dollar on three occasions, in 1981, 1995 and 2008. Compared with those episodes, the recent reaction of sterling is modest.

Figure 1: GBP-USD exchange rate



Source: Thomson Reuters Datastream

Figure 2: Effective exchange rate and terms of trade



Source: Thomson Reuters Datastream; Central Statistics Office

A sharp depreciation of sterling would push up Irish import prices and make exports less competitive. However, as a small open economy, Ireland is a price-taker on world markets. For example, multinational pharmaceutical companies usually price in US dollars, so the recent depreciation of the euro against the dollar has tended to push up on both Irish export prices and nominal GDP.

There is no clear link between exchange rate movements and Irish export performance as companies adjust their profit margins.

The UK's share of Irish exports has fallen over time though more labour-intensive sectors like agriculture and traditional manufacturing remain more exposed to the UK market. Companies in these sectors are likely to be price-takers, so they would tend to pass the weaker sterling into lower profit margins in the short term, cutting their prices in euro but keeping them constant in sterling. This weak pass-through between exchange rates and trade prices (Figure 2) means that the impact of sterling depreciation on Irish GDP would be reduced.

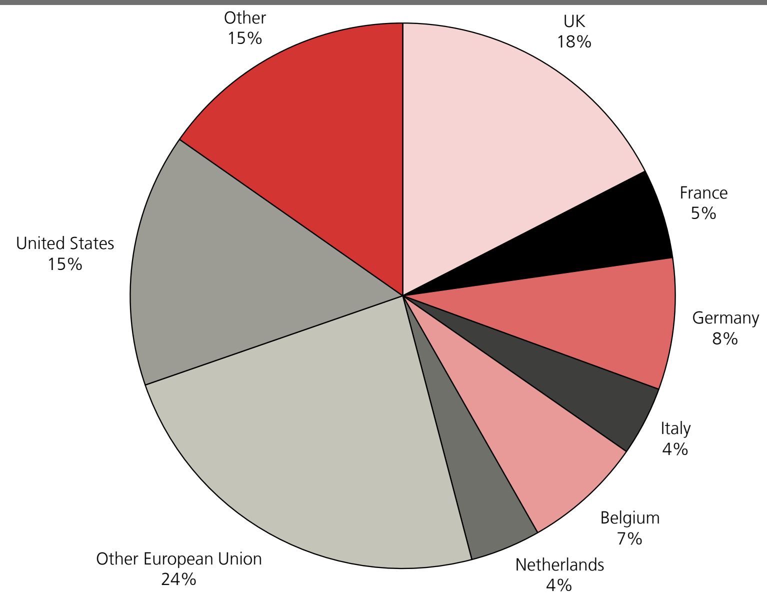
Between 2006 and 2008 sterling depreciated by 43.5% against the euro from 66.8p to 96.1p. This contributed to a 7% rise in Ireland's nominal effective exchange rate. Irish exports grew by 9.6% in 2007 despite the appreciation before falling back 0.1% in 2008 and 1.1% in 2009. However, Irish export markets rose by just 0.5% in 2008 before contracting by 11% in 2009. This means that Ireland actually gained export market share despite the appreciation of the euro against both sterling and the dollar through 2006-2008.

Potential trade effects of Brexit

Ireland's trade exposure to the UK has diminished over time. In 2015, the UK's share as an export destination had fallen to 14%, down from levels exceeding 50% in the 1970s. The decline in the UK's share of Irish imports has been less marked. In 2015, 27% of Irish goods imports still came from the UK. This means that Ireland runs a small trade in goods deficit with the UK, worth €2.3bn in 2015 or just over 1% of GDP.

Ireland's exposure to the UK economy has diminished over time.

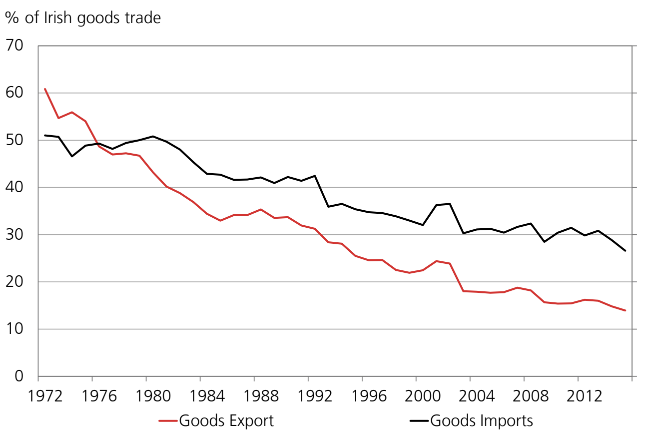
Figure 3: Share of Irish exports of goods and services by country



Source: World Trade Organisation

The UK's export share varies markedly by sector. It accounts, for example, for 6% of chemicals exports but 50% of agricultural exports; similarly, it is an especially important export destination for semi-manufactures such as clothing. Analysis of the 2012 Census of Industrial Production (CIP) shows that foreign-owned companies exported 11% of their output to the UK, but this figure rises to 43% for indigenous manufacturers. This means that 107,000 jobs in agriculture and a further 160,000 in the traditional manufacturing sector would be exposed to any disruption in trade with the UK.

Figure 4: UK share of Irish goods trade



Source: Central Statistics Office

Table 2: UK share of Irish export trade, 2015

	UK €bn	Total €bn	UK export share %
Food	4.5	9.9	45%
Beverages and tobacco	0.3	1.3	26%
Crude materials	0.5	1.8	27%
Fuels and lubricants	0.5	0.8	59%
Chemicals and related products	4.1	64.2	6%
Semi-manufactures	1.1	2.1	54%
Machinery and transport	2.7	16.4	16%
Miscellaneous	1.3	14.2	9%
Total goods exports	**15.5**	**111**	**14%**

Source: Central Statistics Office

Two-year cooling-off period underappreciated

A key point is that disruption to Irish trade with the UK would only occur in a worst-case scenario where negotiations failed to produce a trade agreement. Article 50 of the Lisbon Treaty provides for a two-year exit period, during which the UK would remain subject to all EU treaties including the single market. During this time, there could be no imposition of tariffs, custom or border controls that could disrupt trade.

The UK Foreign and Commonwealth Office (FCO) has said that it would be difficult to secure a free-trade agreement within two years. For example, the Canadian-EU trade agreement (CETA) negotiations have taken seven years and have yet to be ratified. Should the EU and UK fail to secure a trade agreement within the allotted time, an extension of the two-year period would probably be agreed. The agreement of all EU members to such an extension would be required, possibly providing an opportunity to wring concessions from the UK.

Tariffs and quotas would only be imposed in a worst-case scenario where the UK failed to negotiate a trade agreement with the EU.

Our view is that the UK would ultimately maintain its membership of the single market. Some fudge would be required on the free movement of people, allowing the UK some autonomy on migration, but essentially the status quo would most likely be maintained. This would be close to the Switzerland model. Tariffs would only be imposed in the unlikely event that the UK failed to secure an agreement. In this case, trade between the UK and the EU would be subject to World Trade Organisation (WTO) rules.

However, even if the UK did secure single market access, many studies have shown significant benefits of EU membership on trade flows, based on gravity models, beyond the impact of free-trade agreements. For example, Morgenroth (2015) estimated that the UK's membership of the EU has increased trade flows by 21.6%. At face value, this suggests that Brexit would reduce Ireland's exports to the UK by a similar amount. Given the UK's export share of 14%, a 3% decline in Irish goods exports might therefore be likely. However, this impact might only be felt over a very long time period. For example, the experience of the former Czechoslovakia, Soviet Union and Yugoslavia show that trade linkages persist long after the disintegration of political blocks. Instead, the risk for the UK – and hence Ireland – is that trade flows would benefit less from future market integration within the EU.

Worst-case scenario of UK losing single market access

In a worst-case scenario where the UK left the EU without securing single market access, trade would be governed by WTO rules. Under these rules, each member must grant the same 'most favoured nation' (MFN) market access, including charging the same tariffs to all WTO members. The UK would face the EU's MFN tariffs which are applied to all WTO members (Figure 5).

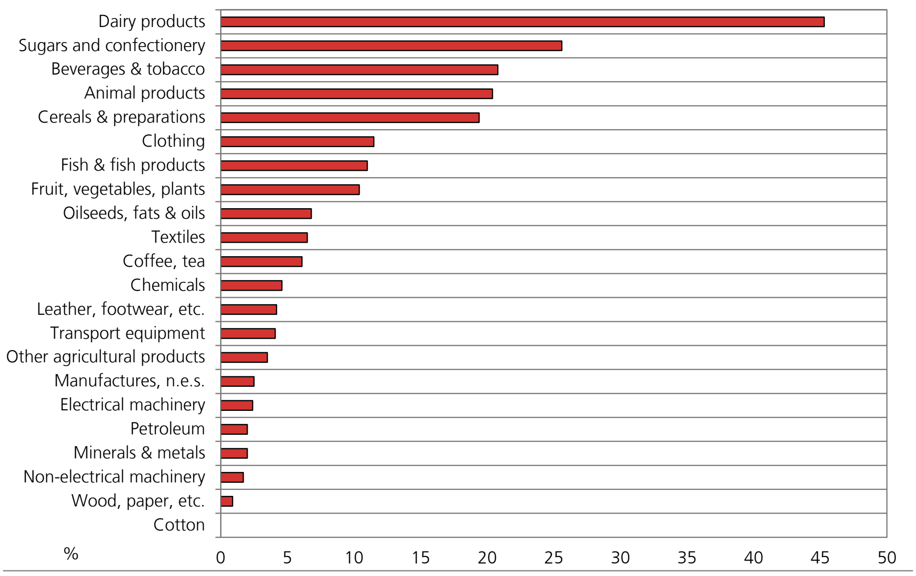
Presumably in such a scenario, the UK would seek to impose retaliatory measures with similar tariffs imposed on imports. Unfortunately for Ireland, the tariffs applied by the EU on agricultural products are exceptionally high, potentially provoking an aggressive response by the UK. The WTO rules would not allow the UK to impose different tariffs on EU imports to those from the rest of the world.

UK exporters to the EU would face tariffs, currently 4.6% on average for manufactured goods.

Alternatively, the UK could decide to impose lower tariffs on some imports. Similarly, pro-Brexit campaigners have suggested that the UK could conclude new free-trade agreements with other countries with the aim of lowering costs. Ireland's agri-food sector could be exposed here, leaving it at risk of heightened competition from low-cost producer countries.

The FCO has said that the process of the UK changing the terms of its WTO membership would not be straightforward. All WTO members would have to agree to how the UK would take on the rights and obligations it had formerly enjoyed as a part of the EU. Potentially, the UK's market access to WTO member markets would be open to question during this negotiation process.

Figure 5: EU common external tariffs



Source: World Trade Organisation

A key point is that no exemptions for Irish-UK trade could be arranged given Ireland's commitment under the EU treaties. This would be forbidden as Ireland would remain part of the EU. Moreover, the WTO's non-discrimination rules would apply, so it would not be possible to have specific bilateral agreements for particular products. In other words, the type of trade agreements between Ireland and the UK prior to EU membership in 1973, which provided special access for agricultural products, would not be legally possible.

Tariffs and red tape could hurt Irish exports to the UK, alongside higher levels of competition from non-EU countries.

Non-tariff barriers especially disruptive for agri-food sector

Brexit could lead to the re-imposition of border controls and customs between the UK and Ireland. The additional costs of complying with rules of origin checks, import licence and other documentation requirements would raise the cost of trade between the UK and the EU. The larger the regulatory differences between the EU and UK became, the larger these non-tariff costs might be.

Research from the National Institute of Economic and Social Research (NIESR) suggests that these non-tariff barriers can raise costs by 2-4%. And a recent Centre of Economic Performance (CEP) study found that a 2% increase in non-tariff barriers reduced UK GDP by 1.4% in the long run. Such non-tariff barriers could emerge even if the UK secured a free-trade agreement. For example, Norway enjoys single market access but still faces rules of origin requirements and anti-dumping duties. The UK would probably attempt to remain consistent with EU single market rules on product standards and mutual recognition in order to minimise the disruption to trade. Nonetheless, such differences could be more severe in the agri-food sector given UK concerns on current EU regulations on plant pesticides, GM crops, and animal and food labelling.

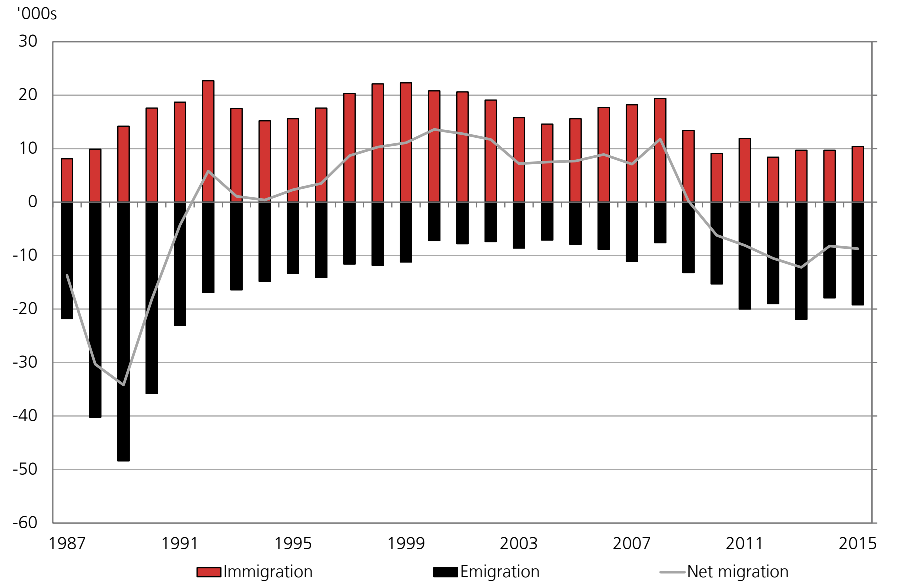
Migration and travel

Brexit would open the possibility of restrictions on the free movement of people between Ireland and the UK. Our view is that even in the event of a vote to exit the EU the UK would ultimately secure some limited autonomy on migration while the status quo in terms of the free movement of people would essentially be maintained.

It is unclear what impact Brexit might have on the common travel area between the UK and Ireland, but it would likely be impacted by EU negotiations.

Currently both Ireland and the UK have opted out of the Schengen agreement covering 26 EU countries that have abolished passport and border controls. Instead, there is a common travel area (CTA) covering Ireland and the UK. One benefit of the CTA is the absence of controls border between Northern Ireland and the Republic of Ireland.

Figure 6: Inward migration between Ireland and the UK



Source: World Trade Organisation

It is far from clear what impact, if any, a vote for Brexit might have on the CTA. Unlike trade relations, there would be no restriction on the Irish and UK governments continuing with the CTA in its present form and the imposition of border controls would be a radical departure. However, relations between the UK and Ireland could be influenced by broader negotiations between the EU and UK. The FCO has flagged that "questions would also need to be answered about the Common Travel Area".

Since 2010, net migration to the UK from Ireland has equalled 53,900.

The latest Central Statistics Office (CSO) data indicate that between 2010 and 2015 net migration to the UK was 53,900, with 113,300 persons emigrating, offset by an inflow of 59,200 immigrants from the UK. The ESRI estimates that had the 60,000 outflow of emigrants to the UK between 2011 and 2013 been curtailed, the impact of the higher unemployment rate would have reduced Irish nominal wages by 4%. Recent estimates indicate that almost 400,000 people residing in the UK in 2011 were born in the Republic of Ireland while close to 230,000 British-born people were resident in Ireland. Should the UK opt to leave the EU the residency rights of both these groups could become an issue. That said, the European Court of Justice has ruled that those with permanent residency would be entitled to remain in EU countries.

UK still an important market for Irish tourism

The UK is an important market for both tourism and business travel. CSO data indicate that in 2015 Britain accounted for 41% of overseas trips to Ireland, with a spend of €971m (excluding travel fares), or approximately 0.5% of GDP, while in Ireland. This compares with total spending by overseas visitors to Ireland of €4.2bn or 2% of nominal GDP. UK visitors accounted for 25% of hotel stays measured by number of bedroom nights. The smaller proportion must in part reflect the UK's exceptionally high share of same-day trips to Ireland for business (83%).

The UK accounts for 30% of holiday trips to Ireland.

A key point is that Ireland and the UK already implement border controls on flights between the two countries despite the CTA. Should Brexit occur, the UK could still participate in the European Common Aviation Area (ECAA), which would provide UK airlines with access to the single aviation market. Membership of ECAA already extends to 38 countries, including Norway, Iceland, Albania, Bosnia & Herzegovina, Croatia, Macedonia, Montenegro, Serbia and Kosovo.

So, assuming the UK joined the ECAA, Brexit would have little impact on air transport in terms of route access, capacity or pricing. One small potential benefit for airlines and ferry operators would be the return of duty-free shopping. The tourism sector would of course be particularly exposed to a sharp depreciation in sterling against the euro.

Table 3: Share of Great Britain in travel and tourism into Ireland in 2015

Overseas trips to Ireland	41%
For holiday leisure (>1 day)	30%
For business (>1 day)	48%
Hotel stays (proportion of nights)	25%

Source: Central Statistics Office

The energy sector

Ireland is in effect part of the UK energy market.

Ireland is in effect part of the UK energy market. In 2014, Ireland imported €6.5bn of energy products, 90% of which came from the UK. Ireland's electricity and gas grids are both joined to the UK through two connectors for each. The UK in turn has interconnectors with Europe and Norway. However, Northern Ireland relies on imports from the Republic of Ireland to make up for its own shortfall in electricity generation.

How energy markets would work in the event of Brexit remains an open question. Tariffs on EU exports to the UK could raise energy costs there while the UK could impose tariffs on Ireland, which could have a significant impact on competitiveness. Ireland could possibly seek a rebate from the EU for the knock-on impact of higher energy costs from EU tariffs on the UK. A further complication would arise if UK regulation of its energy sector were to diverge from the EU's goal of creating an internal energy market (IEM).

In short, Brexit might lead to higher energy costs for both Irish companies and households.

Foreign direct investment

A potential marginal benefit of Brexit for Ireland might be attracting FDI flows at the expense of the UK, given uncertainties on the latter's access to the single market. However, the UK government is currently planning to cut its corporation tax rate to 17% by 2020 which will improve its competitive position vis-à-vis Ireland. The UK is also attractive for FDI for a number of other reasons, including market size, financial market developments, technology and labour market flexibility.

Ireland could see a small marginal benefit by attracting FDI at the expense of the UK.

Furthermore, recent empirical analysis by the ESRI suggests that the positive impact on Ireland's attractiveness as a location for FDI would be marginal. In a scenario where UK single market access was reduced by 50%, the probability of multinational companies investing in Ireland would rise by 0.3 percentage points from 4.0%. These estimates should clearly be treated with care given the uncertainties relating to Brexit.

One opportunity for Ireland might be its ability to benefit from any negative impact on the UK's financial services sector. The UK's inward FDI stock is estimated at $1.7trn of which 45% was accounted for by financial services. A key element of the debate on Brexit has been the potential impact of financial institutions losing 'passporting' rights, which allow them to sell services across the EU. Should financial institutions relocate from London, Ireland might expect to attract some of these investment flows.

Impact of Brexit on the Northern Ireland economy

Ireland is unique amongst euro-area countries as it shares a land border with the UK. While arrangements applying to the movement of people might not be directly affected by Brexit, the UK might have to impose customs controls on the goods trade with the Republic as it would no longer be a member of the EU customs union. Again, these controls could only be imposed at the end of the two-year exit period.

As noted above, the UK currently accounts for €13.8bn, or 14%, of Irish goods exports. Of this, Northern Ireland accounts for just €1.7bn, or 1.6%, of goods exports – a relatively small share. However, cross-border trade has grown sharply over time, rising from €1.65bn in 1996 to €3.0bn in 2013. The Republic of Ireland accounts for close to 33% of Northern Ireland's goods exports. So, the imposition of non-tariff barriers could be particularly costly for Northern Ireland.

Uncertainty on Brexit would undermine the potential benefits of Northern Ireland's independent corporation tax rate.

A recent report by the Northern Ireland Assembly estimated that the economy there would lose €1bn as a result of Brexit and register a 3% drop in GDP. Trade effects, with potential spill-overs onto productivity growth, would again be key factors. Similarly, uncertainty on the UK's future membership of the EU would undermine the potential benefits of Northern Ireland's independent corporation tax rate. Attracting FDI into Northern Ireland would clearly be problematic with access to the EU single market at risk.

Also at risk would be transfers under the EU Common Agricultural Policy (CAP). This has been estimated to provide 82% of farm income in Northern Ireland. According to the European Commission, €3bn was expected to have been paid through 2014-20. In the event of Brexit this income stream would be lost, although it could be replaced by the UK Treasury.

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