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Report

Brexit and its Impact on the Irish Economy

David Purdue and Hansi Huang
NTMA Economics

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Main Points

- The latest polling data suggests the UK will vote to stay within the European Union (EU). Despite this, there is a material chance that the British public vote to exit.
- If Britain does vote to leave, a withdrawal agreement would be negotiated between the UK and the EU. This agreement would ultimately be a trade-off for the UK between the degree of access to the EU Single Market and freedom from EU regulation and legislation.
- The ultimate economic impact of Brexit on Ireland will be governed by the nature of the withdrawal agreement between the EU and the UK. The larger the degree of access to the EU market negotiated by the UK, the smaller the effect on Ireland.
- Whatever the deal put in place it is likely that Irish trade to the UK will suffer, especially the agri-food industry. The energy market may be affected negatively while FDI into Ireland and the financial services sector might see some positive knock-on effect.

Introduction

Britain’s position in Europe has long been fraught with domestic tensions. In recent years the discord towards the EU has grown in step with the rise in popularity of more nationalistic sentiment (epitomised by Ukip). Many British politicians view the EU as a bloated bureaucracy that hampers the growth of the UK through burdensome levels of regulations. The EU is also seen as the driver of the perceived immigration problem in the UK. It is in this environment that, during campaigning for the recent UK general election, Prime Minister David Cameron promised to hold a simple in/out EU referendum by end-2017. Following the Conservative Party’s majority victory in the election, and the promised referendum on the horizon, the probability of a UK exit from the EU has increased.

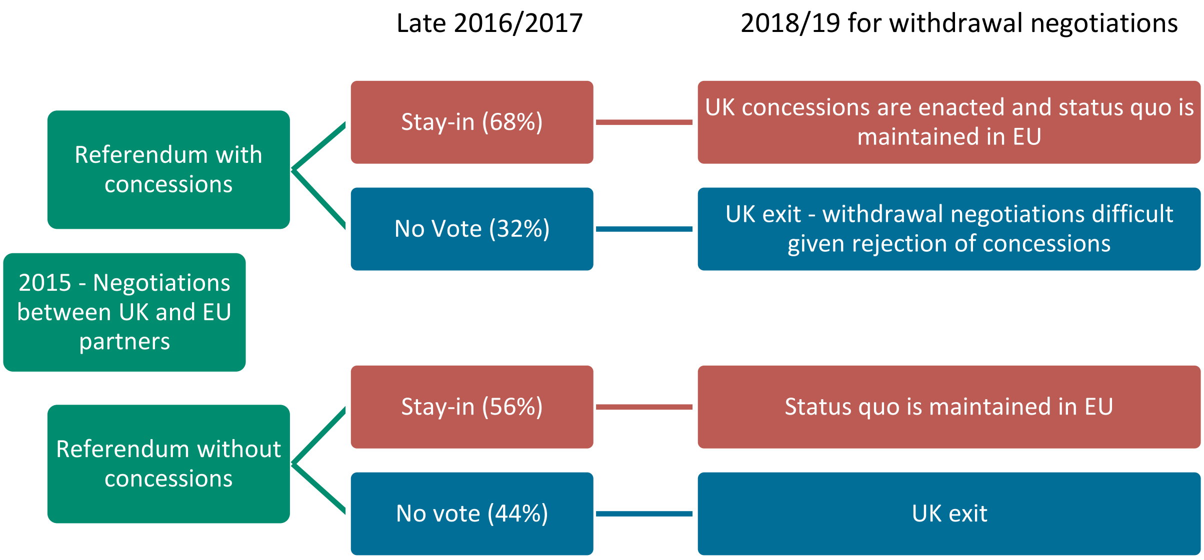
This paper looks to discuss the likelihood of such an exit – or “Brexit”– and the impact it would have on Ireland. It details firstly what the in/out referendum could look like and how likely a British exit is according to polling data. Assuming a pro-exit result, we then discuss what would happen in its aftermath. Lastly, we view the potential impacts Brexit would have on the Irish economy, in particular on trade, Foreign Direct Investment (FDI), the agri-food sector, the energy sector and the financial services sector.

First step is negotiation of concessions for the UK

Before setting a date for the referendum Britain will likely attempt to renegotiate its 'relationship' with the EU. The outcome of the negotiations would then be put to the British electorate. It is hoped that those calling for Brexit could be placated by concessions in certain areas. The areas the UK Government wishes to re-negotiate include migration within the EU (and specifically a clamp-down on benefits for EU migrants), an opt-out from "ever closer union", safeguards for the City of London, guaranteed access to the single market for non-euro area members, an end to protectionism in services, and powers for national parliaments to issue "red cards" on EU laws.[1]

We analyse two different outcomes: whether the UK government is able to negotiate favourable terms or not (see figure 1). In reality there is a spectrum of outcomes regarding concessions. The more favourable the concessions, the more likely the Conservatives would campaign in favour of staying inside the Union. With the opposition parties also advocating a pro-EU stance, the stay-in side most likely wins the referendum. Of course, if the terms were deemed unacceptable, the Conservatives could be split on the issue with the effect that exit becomes more likely.[2]

<u>Figure 1: Simple Diagram of the possible outcomes</u>



Figures are average of latest YouGov opinion polls; percentages are excluding undecided voters

The UK Government has expressed optimism about securing concessions. In practice, there may be limited scope for meaningful ones. If any of the treaties require amendments to incorporate the proposed concessions it would mean each country needs to individually ratify the changes. Ireland

[1] See the Telegraph 21 May 2015.
[2] The discord within the Conservative Party reported upon in June regarding the "purdah" debate show that the party is by no means fully behind David Cameron on this issue.

and others would need to do this by referendum. This could be arduous and time-consuming. More likely Europe will offer concessions that which avoid the need for treaty reform. The implication is that the concessions may not be as far reaching as the British Government would wish.[3]

Polling suggest stay-in scenario is most likely

It is likely the UK would vote to stay in given favourable concessions, in particular on immigration and on welfare benefits to immigrants. When polling asks the exit question in terms of a renegotiated membership versus exit, the stay-in side gets 68% of the vote when undecided are excluded. Polling in the no concessions scenario is weaker but still suggests that 56% of people would vote to remain within in the EU (excludes undecided voters).[4]

Interestingly, in recent polling, voters who consider themselves Conservatives poll at 39% without renegotiation and 63% with renegotiation.[5] If this strong Conservative support were to materialise - allied to the traditionally pro-EU Labour and Liberal-Democrat parties - it is hard to see an exit result. UK conservatism in economic matters as evidenced in general election and Scottish referendum would be a key factor. A stay-in campaign detailing the risks surrounding EU exit would play into this conservatism.[6] Loss of exports, a smaller City of London, risks to the stability of Northern Ireland, and loss of influence in Europe could all be highlighted.

Factors that could lead to an exit through referendum

Despite the strong arguments for a yes vote in the referendum, there is a material chance that the British public vote to exit. The likeliest path to exit would be a failure by the UK to negotiate favourable concessions prior to the referendum. In this scenario, the Conservative Party could be split on the issue. This could lead to a poorly-run yes referendum campaign which fails to alert the dangers of exit. Nationalist sentiment may be whipped up come referendum time by Ukip and the fringe of the Conservative Party. There is a possibility that even after negotiating favourable concessions, the fringe of the Conservative party does not back the Prime Minister and a fractured yes campaign fails to convince the British public.

[3] Downing Street has confirmed in recent days that the referendum may take place before any treaty change.
[4] The figures are the average of 28 polls taken in 2014 and 2015 to date. Polling data can be found here.
[5] Source: YouGov polling data June 2015.
[6] One issue with the inaccuracy of the 2015 UK general election polling was its inability to account for the "Shy Tory" factor. Polling has consistently underestimated the underlying Conservatives support in the last two decades. Which side such a bias in the data is likely to bolster is difficult to say. But in general shy conservative voters are likely to vote for the status quo.

If UK vote to exit what happens next?

The Lisbon Treaty introduced a formal mechanism by which a member state can exit the EU. Under Article 50 of the EU Treaties, the UK would notify the EU of its withdrawal and the EU is then obliged to negotiate a 'withdrawal agreement'. This agreement would cover the UK's future trade and labour deals with the remaining EU member states. To discourage exit, the dynamics of Article 50 are naturally biased against the country leaving. First, if the UK notifies the EU of its intention to leave, it cannot change its decision.[7] This reduces the UK's leverage in negotiations. Second, the UK members of the EU Council would not vote or be party to the negotiations. Excluding the UK, the overall ideology of the remaining EU members may become more protectionist in nature. This could affect UK's trade terms. If agreement is reached, the EU Treaties would cease to apply to the UK on entry into the withdrawal agreement or after two years if no new agreement was concluded.

Article 50 lessens the UK's leverage in negotiations and the UK government may try to avoid this route. One method is for the UK government to use an exit referendum result as a hard-line negotiating mandate, with the precise legal status of the negotiations left hanging – and then trigger Article 50 as a mere formality, once talks are concluded.[8] This strategy is likely to draw the ire of the EU negotiators. In truth, at this time it would be impossible to know even the broad strokes of the withdrawal agreement. Whatever the exact detail of the agreement and how it comes together, UK government are likely to face a trade-off between the level of access to the EU Single Market and freedom from EU regulation and legislation.

Potential impact on Ireland - It all depends…

The economic impact of Brexit on Ireland will be largely determined by the nature of the withdrawal agreement between the EU and the UK.[9] Britain would prefer to retain full access to the single market and thus minimise the impact of a UK exit. The political landscape makes this unlikely. The EU is likely to impose costs on the UK upon its exit so as to not undermine the basis for EU membership and encourage others to exit. In the end, the flow of goods, services and labour between the UK and the EU is likely to be restricted. Ireland would be significantly impacted by this eventuality as the EU country most connected to the UK. Open Europe have estimated that "in a worst case scenario" Ireland could see a permanent loss of 3.1% to GDP by 2030. Even in the best

[7] The decision to leave does not need to be endorsed by other member states and it cannot be blocked.
[8] Open Europe, a British think tank, posits this tactic in their Brexit report, available here.
[9] Like negotiations with any non-EU country, trade agreements would be made on a pan-EU level and not directly between Ireland and the UK.

case scenario the loss would still total 1.1% of GDP.[10] These figures should be taken as illustrative rather than as forecasts but it is plausible that Ireland is facing at least a minor negative shock from Brexit.

The potential impact on Ireland from Brexit is considered via five channels: First, trade impacts are discussed. Second, the impact on FDI is detailed. We then analyse three sectors in which Irish-UK connections are particularly relevant – agri-food, financial services and energy.

Effects on Trade – Likely negative

The first effect considered, and perhaps the most important, is the effect on trade with the UK. The UK is the second largest single-country export destination for Ireland for goods and the largest single-country export destination for services. For 2013, the UK accounted for 16.1% of Ireland's total goods exports, behind only the USA. The main goods exported were chemical and related products (approx. 35%), agri-food produce (roughly 30%) and machinery and transport equipment (approx. 13%). The UK accounted for 17.8% of total services exports. Computer services followed by transport, financial and insurance were the main services exports to the UK in 2013. The cost of trade is likely to increase if Brexit occurs, so exports volumes to the UK would fall.

Figure 2: Ireland's 2013 Exports by Destination

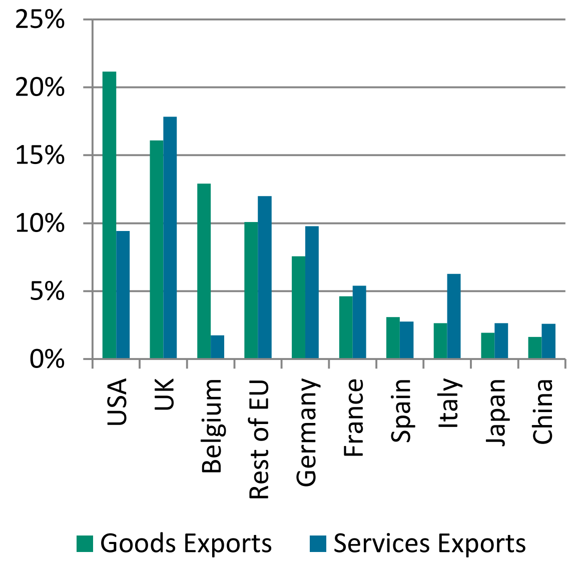
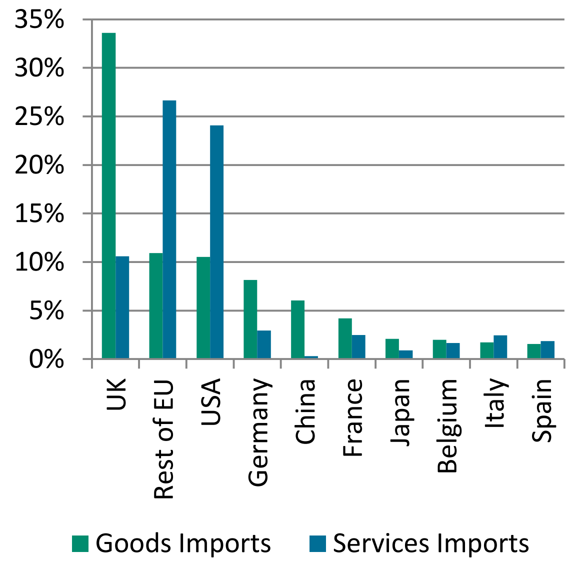


Figure 3: 2013 Imports by trading partner



Source: CSO, UN COMTRADE

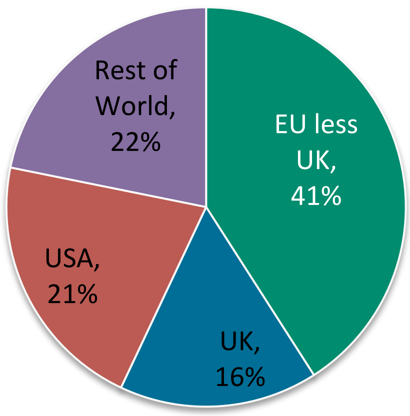
[10] Raoul Ruparel, Open Europe Blog, April 2015

Ireland imports more goods from the UK than any other country. In 2013, 33.6% of all goods imported to Ireland came from the UK. This is largely due to the presence of entrenched supply chain linkages between the two countries. Large UK retailers operating in Ireland import a lot of their goods to sell in Ireland and UK wholesalers often supply the Irish market (both Irish and foreign owned retail outlets). Any increase in trade barriers or tariffs would reduce these trade volumes and increase import prices for Irish-based firms. Such increases in the cost base would likely be passed onto the customer in some manner.

The UK is a major trading partner for Irish-owned enterprises and their employment. Indigenous manufacturing firms sold 43% of their exports to the UK, while foreign companies exported 11% of their produce.[11] To highlight the importance of UK trade to Ireland, consider that exports to the UK might only account for 16% of Ireland's total exports, yet 30% of all employment is in sectors which are heavily related to UK exports. It is likely that these types of indigenous sectors would be disproportionately affected by any detrimental impact on trade.

Further to cost increases, sterling may weaken vis-à-vis the euro due to Brexit. The pound may fall because of the perceived threat to Britain's access to the single market in the future. Indeed, even in the event of Britain remaining in the EU, sterling may depreciate in the run up to the referendum due to the uncertainty regarding the referendum result. If this were to occur, Irish exports would become more expensive from a British perspective. Empirically we estimate that a 1% appreciation in the euro (i.e. sterling depreciation) would lead to a fall in exports to the UK of 0.5%.

<u>Figure 4: Importance of EU to Irish goods exports</u>



Source: UN Comtrade database

Trade data also shows the importance of the EU market for Irish trade. The EU (excluding the UK) accounted for 41% of Irish goods exports and 29% of Irish goods imports in 2013. For services, exports and imports vis-à-vis the EU accounted for 38% in both categories. For trade purposes, Ireland would wish to remain close to both the UK and the EU – something which could be increasing difficult to do following Brexit. Ireland could have an important strategic and political role to play in any negotiations regarding the UK's withdrawal.[12]

[11] CSO Census of Industrial Production 2012
[12] For more on the political implications for Ireland surrounding Brexit, see the report from the IIEA.

Depending on the withdrawal agreement negotiations, a physical border might be needed to delineate Northern Ireland from the Republic. The establishment of border controls may deter trade and labour movement between north and south as well as increase trading costs. There are also costs associated with the upkeep of the border, especially security. The other impact of the border would be political and symbolic. The dismantling of the border following the 1998 Good Friday Agreement has contributed to improved cross-border relations and the introduction of a physical border could reverse this.

Effect on FDI – possibly positive

Foreign firms based in the UK might consider relocation following Brexit, negatively affecting the UK's FDI inflows. This may be especially pertinent for firms who use the UK as a base for its EU operations. The uncertainty regarding exit may also negatively impact firms who are considering locating in the UK prior to the referendum taking place. The UK's FDI inflows could be diminished, with some relocation of FDI to other EU Member States. Ireland could be a beneficiary from this displaced FDI, particularly if foreign investors prefer an English-speaking labour force. US-led investment is the obvious example, given the IDA's success in attracting American investment.

The withdrawal agreement will be the main determinant of the impact of Brexit on Irish FDI. If, as is likely, access to the single market is restricted then FDI would likely flow from the UK to the remaining EU members. Research suggests membership of the EU increases FDI from outside the EU by 27%.[13] This implies Brexit could result in a drop in the UK FDI stock from non-EU Member States of approximately €189 billion (or 27% of the UK stock).[14] Approximately 3% of FDI inflows into the EU from outside are directed towards Ireland. At that rate, Ireland could attract some €6 billion of the displaced UK FDI, equivalent to 20% of Ireland total FDI inflows for 2013.[15]

A caveat to this simple analysis is that the UK will likely try to compete more aggressively in anticipation of this loss in FDI. The UK could lure FDI away from Ireland with lower taxes, higher subsidies and other incentives. The EU state aid rules may no longer apply to the UK and could give the UK a competitive advantage over the remaining EU nations. Considering this, the figure of €6 billion mentioned above is likely near the upper limit of the impact on Irish FDI.

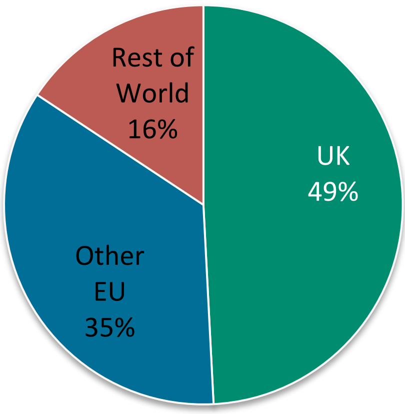
[13] Gary Clyde Hufbauer and Jeffrey J. Schott, 'Fitting Asia-Pacific Agreements into the WTO system' in Richard Baldwin and Patrick Low (eds.) Multilateralizing Regionalism: Challenges for the Global Trading System, Cambridge: Cambridge University Press, 2009.

[14] 2013 OECD data

[15] In the IIEA's report, analysis by Edgar Morgenroth of 2012 data estimates similar figures.

Effect on Agri-Food Sector - negative for Irish producers

Figure 5: Destination of Agri-food Exports



Source: CSO

As stated above, the UK is the second largest export destination for Ireland for goods and the largest trading partner for imported goods. The Irish agri-food sector is much more dependent on the UK as a trading partner than Irish industry in general. In 2014, Irish agri-food exports (excluding fish) to the UK amounted to €3.3 billion or 49% of Ireland total agri-food exports. Similarly, Irish imports of food and agricultural produce from the UK amounted to €3.3 billion or 46% of total agri-food imports.

The main impact on UK-Irish agri-food trade would come from the potential re-introduction of border/customs procedures and possibly tariffs. Trade costs may increase because of the additional costs of procedures such as origin checks, increased documentation and physical border checks. This could put upward pressure on Irish export prices to the UK, harming competition. If some tariffs are re-introduced on agri-food trade, this could put Irish exporters to the UK market at another disadvantage vis-à-vis their UK competitors. On the import side, there could be upward pressure on import prices for Irish-based firms and retail prices for Irish consumers when importing from the UK.

The UK's trade policy with third-party countries could have a negative effect on Irish exporters to the UK. Under EU rules, trade policy with non-EU countries is conducted at a pan-European level but following Brexit the UK can follow its own independent trade policy with these countries. If the UK signed Free Trade Agreements with non-EU countries that focussed on opening up the agri-food market, this may lead to greater competition on the UK market for Irish suppliers.

Changing agri-food regulatory landscape

There could be additional costs from complying with two different regulatory regimes were the UK to diverge from the EU regime markedly.[16] For instance, it is not necessary for an animal slaughtering facility to be certified by both the UK and Irish authorities due to an EU mutual recognition agreement that is in place currently. After Brexit, with no such agreement in place, duplication may arise. Since EU regulation is similar to global standards, it is not expected that UK standards will be drastically different than those of the EU. That being said, there are a number of issues that the UK

[16] Alan Matthews, Implications of Brexit on the Irish agri-food sector 2015, TCD working paper

has voiced concerns on in the past. These include regulation on plant pesticide products, GM crops and animals, and food labelling. UK regulators may address these issues after exiting the EU.

Within the EU, the loss of the UK could spark a drive towards a position of greater protection for EU farmers following Brexit. The UK has long been in favour of open trade in agriculture and its exit would likely shift the balance of opinion to greater protectionism. The extent of this shift would likely be mitigated by the budgetary consequences of Brexit. The UK is the second largest net contributor to the EU budget and if countries were intent on increasing or even simply maintaining farm support levels, they would need to contribute more to the EU budget. Such a budgetary increase may dampen their protectionist intentions.[17]

Effect on Energy Market

The Irish energy market is heavily reliant on its connection to the UK market. Ireland imported €6.5bn worth of energy products in 2014 (3.6% of real GDP), more than 90% of which came from the UK.[18] The UK and Ireland's gas grids are linked via two interconnectors: the majority of Ireland's gas consumption is supplied via the Scotland interconnector. Since 2001, the two countries' electricity grids are also linked via the Moyle Interconnector and the East-West Interconnector (operational since 2012). In turn the British energy market is connected to both mainland Europe and Norway. It is less dependent on imports than Ireland given its North Sea reserves. The UK imported 37% of its oil demand in 2012 and 47% of its gas needs. These figures have increased in recent years as the North Sea reserves have been depleted.

Ireland is in effect a regional extension to the British energy market and takes any price that is determined by that market.[19] If, upon leaving the EU, energy import tariffs were imposed on the UK these may in turn be passed onto the Irish market also. A 10% increase in energy costs would lead to a fall in GDP of 0.4%, based on historical estimates. The knock-on effect on competitiveness and prices would be also harmful. Ireland may be able to negotiate a rebate from the EU relating to any tariff imposed on the UK which led to an increase in Irish energy costs. Given its membership of the single market it could be argued that any tariff indirectly imposed upon Ireland would contravene the spirit of the free market.

Regulation of the energy market in the UK may diverge from that of the rest of the EU following Brexit. Ireland is committed to the EU policy of creating a genuine Internal Energy Market (IEM),

[17] For more on Brexit and the Irish agri-food sector, see Alan Matthews' paper referenced in footnote 16.
[18] See CSO Trade Statistics December 2014
[19] This is particularly true for the gas market. Gas is the marginal fuel used in electricity production and so sets Irish electricity pricing.

encompassing electricity and gas networks across Europe. The existence of a competitive IEM would contribute to diversification and thus to security of supply. If the UK regulation were to diverge from that of the EU, Ireland may be stuck trying to serve two sets of regulations. This would increase costs while also limiting Ireland from obtaining the benefits of the IEM. In the long-term, following Brexit, Ireland may need to connect to mainland Europe with the associated infrastructure costs.

Financial sector could see a positive impact

The City of London will remain a global centre for finance in the event of an EU exit but some activity may be lost. Its central role in foreign exchange trading, securities trading, insurance, asset management, financial law, and accountancy services is likely to continue. Some activity could be lost as institutions relocate for reasons related to the EU market. If that activity were to be relocated to Dublin, it would be a strong positive for Ireland.

The reasons for relocating are based on access to the single market, regulation and skilled labour. If the UK was outside of the single market, London would not be able to service European financial markets quite as efficiently. Non-EU financial institutions may seek a new bridgehead from which to service the EU market. Banks from outside the EU would no longer be free to set up a subsidiary in London and then branch out to other EU member states. They may look to Ireland as one of the logical places to consider for relocation of their EU base. This would be an opportunity for the IFSC especially given Ireland would be the only English-speaking country left in the EU.

After Brexit, the UK might find itself in a similar situation to that of Switzerland in terms of regulation.[20] Swiss financial institutions only have limited access to the EU.[21] To sell services to EU customers, they must set up branches and subsidiaries inside the union. To maintain access these subsidiaries need to comply with EU regulation and so must continuously update their regulations. To maintain the City's market access and the UK's more generally, the withdrawal agreement would likely stipulate the UK would need to do something similar. If market access was restricted, it would open up further relocation possibilities for Ireland.

Finally, hostility to immigration from the EU is one reason for Britain's dissatisfaction about its EU membership. The City's supremacy in finance is founded in part upon attracting skilled foreign labour. Institutions in the UK may find it more difficult to bring in skilled workers if Britain decides to enact barriers to entry upon exit.

[20] The Economic consequences of Leaving the EU: The final report of the CER Commission on the UK and the EU single market, Centre for European Reform, June 2014, Link
[21] For more on how Switzerland's financial sector operates vis-à-vis the EU, see here.

Conclusion

The most likely outcome suggested by polling data is the UK voting to stay within the EU. That being said there is a material chance that the British public votes to proceed with exit. Upon an exit result in the referendum, a withdrawal agreement would be negotiated between the UK and the EU. The ultimate economic impact of Brexit on Ireland will be governed by the nature of this withdrawal agreement and the treaties that the UK signs with third party countries. It is likely whatever the deal put in place that Irish trade to the UK will suffer, especially the agri-food industry. The energy market may be affected negatively, while FDI into Ireland and the financial services sector might be boosted.

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