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Possible Implications of a Disorderly Brexit for the Short-Term Forecasts

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The forecasts in this Quarterly Bulletin for 2019 and 2020 are based on the assumption that the UK leaves the EU with an agreement before 31 October 2019. If this transpires, a two-year transition period would come into effect during which time the UK would remain a member of the EU customs union and single market. This would represent the most favourable outcome for the Irish economy but the risk of a disorderly Brexit remains and uncertainty has increased since the publication of our April Bulletin. In this Box, we outline the possible implications of a disorderly Brexit on 31 October 2019 for the performance of the Irish economy in 2019 and 2020. The estimates we present are subject to significant uncertainty due to the unprecedented nature of this potential economic shock.

The Central Bank published its estimates of the macroeconomic implications of a disorderly Brexit in the first Quarterly Bulletin of 2019 on 25 January 2019. In that analysis, we discussed the key channels through which a disorderly Brexit would affect the Irish economy. There would be heightened stress in financial markets and a potentially large depreciation of sterling. The deterioration in economic conditions and a more adverse outlook would cause firms and households to cut spending. It is likely that there would be disruption at ports and airports as border infrastructure is unable to cope with the new customs requirements, at least for an initial period. Imports would be affected with implications for firms through disruption to their production processes, and for households through the price and availability of consumer goods. Exports would fall due to an immediate and large reduction in demand from the UK and the fall in sterling.

Table 1: Impact of Disorderly Brexit on 2019 and 2020 Growth Rates

	QB 3 July 2019		Disorderly Brexit	
	2019	**2020**	**2019**	**2020**
Real GDP	4.9	4.1	4.5	0.7
Employment	2.4	1.7	2.3	0.4

Our estimates published in January suggest that a no deal Brexit would reduce output growth by 4 percentage points in the first year. After 10 years the level of output in the Irish economy would be 6 per cent lower compared to a no-Brexit scenario. These estimates remain unchanged. Given that the possible date of the UK's exit from the EU is now October 31 of this year, most of the impact of a disorderly Brexit would occur in 2020. Applying this shock to the Central Bank's latest forecasts contained in this Bulletin would imply that the growth forecast for 2019 would be reduced from 4.9 to 4.5 per cent, while in 2020 growth would fall from 4.1 to 0.7 per cent (Table 1). The rate of growth in employment in a disorderly Brexit would also be substantially lower than the forecast in this Bulletin. As a result, by the end of 2020 our estimates suggest that there would be around 34,000 fewer jobs in the economy compared to the level of employment that could be realised in a no-Brexit scenario. Given that changes in employment typically lag falls in output, the labour market impact of a disorderly Brexit would continue to be felt in a significant way beyond the forecast horizon of this Bulletin.

The fall in output and increase in unemployment in a disorderly Brexit would put pressure on the public finances. Lower output and employment would reduce government tax revenue from a range of sources while higher unemployment would lead to a rise in expenditure. Putting these effects together, our simulation results indicate that a disorderly Brexit would lead to a deterioration in the General Government Balance of around ¾ of a per cent of output in 2020. This would likely imply a return to a General Government deficit next year.

It is important to emphasise that the degree of uncertainty around these estimates is larger than typically associated with modelling exercises of this kind. This is due to the lack of comparable historical precedent of countries leaving the EU or any other major trading bloc. There is substantial uncertainty around how the economy would adjust in a no-deal Brexit: by how much and how quickly would trade flows be affected by the imposition of WTO tariffs, what would be the scale of logistical and supply-chain disruption, how would financial markets and exchange rates react? For our analysis, we have made assumptions on these key transmission channels based on the best available evidence from academic research and other published studies. At the same time, there is an unavoidably high degree of uncertainty around the magnitude, and even the direction, of some of these effects. As a consequence, the estimates in Table 1 should be treated with caution – the impact on the Irish economy could turn out to be more or less severe than reported here.

The Central Bank's estimates of the short-run impact of a disorderly Brexit are more severe than in a similar study by the Department of Finance and ESRI. The main reason for this is that the Central Bank's analysis assumes that a disorderly Brexit would be accompanied by heightened uncertainty and a fall in consumer and business sentiment, and that this in turn would negatively affect spending by firms and households. The Department of Finance/ESRI study places less emphasis on these effects but focusses more on the impact of a disorderly Brexit through the trade channel. The long-run impact of a disorderly Brexit is similar in both studies with an estimated long-run fall in output of around 6 per cent. Whatever the precise magnitude of the economic impact, a disorderly Brexit would present enormous challenges for the Irish economy – especially in the near term – and would result in a loss of output and employment compared to a scenario where the UK remained in the EU.