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UK Economic Performance since the EU Referendum and Implications for Ireland

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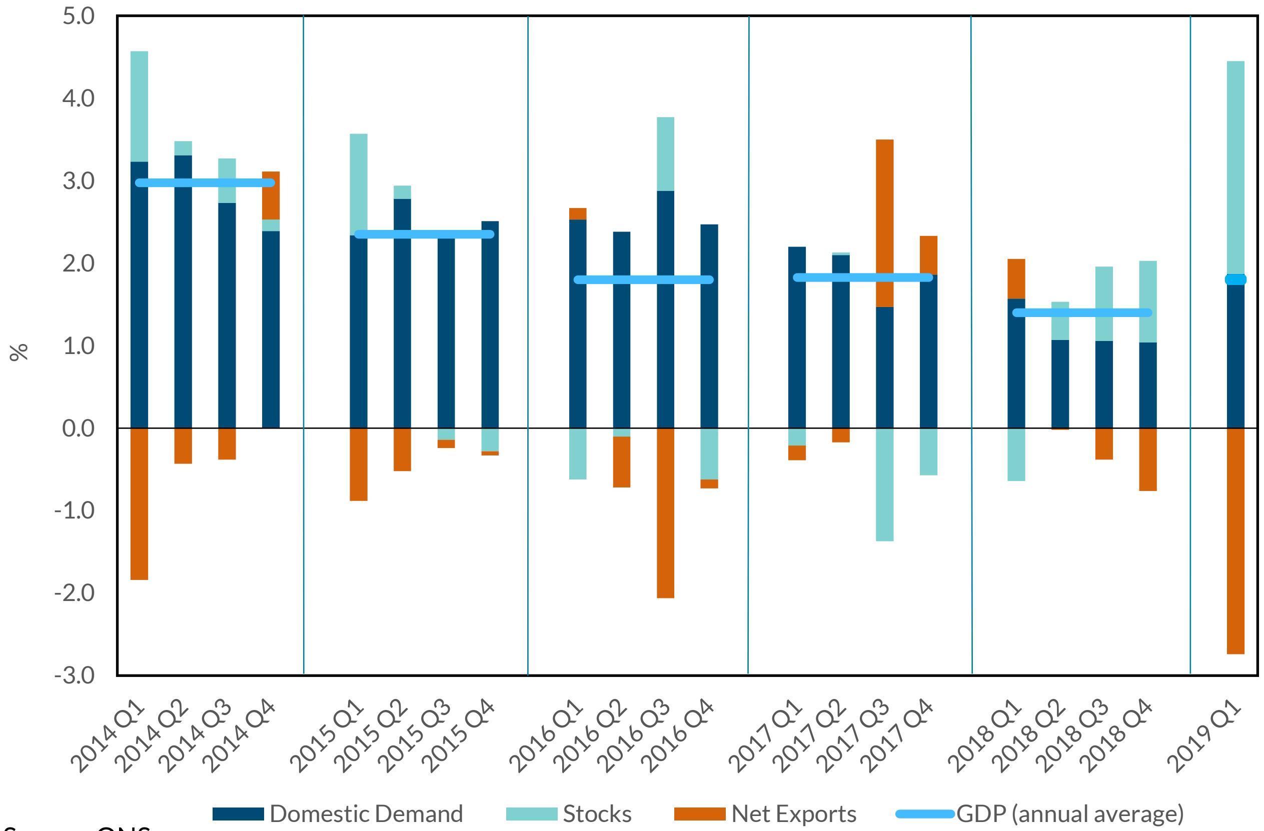
On 23 June 2016, the UK voted to leave the EU and on 29 March 2017 the UK Prime Minister triggered Article 50 – the formal process for countries to officially exit the EU. This two-year period – due to expire on 30 March 2019 – was extended until 31 October 2019 as the UK was unable to ratify the EU-UK Withdrawal Agreement before the March deadline. During the period from the referendum in June 2016 until 31 October 2019, the UK remains a member of the EU with full access to the EU customs union and single market. Despite this, some evidence has already emerged of Brexit-related effects on key UK economic indicators. In this Box, we focus – not on the future potential implication of Brexit for Ireland (which is covered in existing research by the Central Bank and others) – but rather on the performance of the UK economy since the referendum on EU membership in 2016.[1] Close monitoring of current UK economic developments is important given the extensive ties between the two countries and the potential for changes in the UK economy to transmit directly to Ireland. Moreover, examining how Brexit-related weakness in the UK has already affected the Irish economy can provide insights as to how future Brexit shocks are likely to affect Ireland.

Figure 1 shows the year-on-year growth in UK GDP along with the contributions to growth from the main expenditure components. Looking at overall GDP growth (blue line), it is noticeable that the pace

[1] See Conefrey, Thomas, Gerard O'Reilly and Graeme Walsh (2019), "The Macroeconomic Implications of a Disorderly Brexit," Central Bank of Ireland Quarterly Bulletin No. 1 2019. Available at: https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/qb-archive/2019/quarterly-bulletin---q1-2019.pdf#page=23 and Bergin, Adele, Philip Economides, Abian Garcia-Rodriguez and Gavin Murphy (2019), "Ireland and Brexit: modelling the impact of deal and no-deal scenarios," ESRI Special Article. Available at: https://www.esri.ie/system/files/publications/QEC2019SPR_SA_Bergin.pdf

of growth has slowed since the 2016 referendum. Net exports (orange columns) provided a boost to growth in the second half of 2017; however, this waned in 2018. The contribution to overall GDP growth from domestic demand (consumer spending, investment and government spending) has also weakened over time.

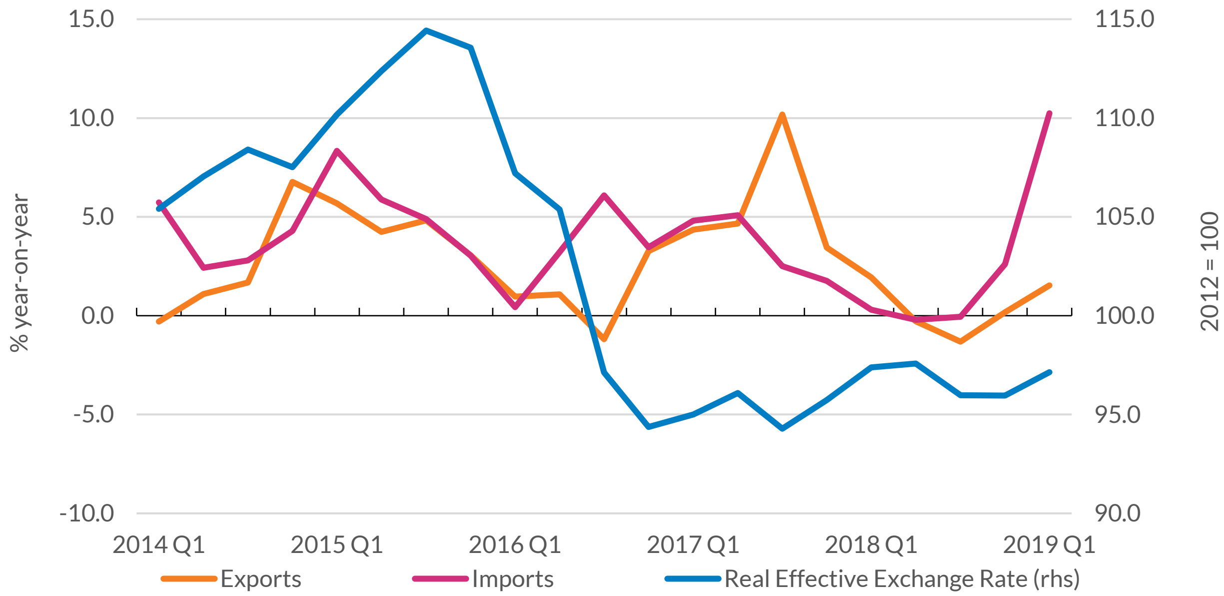
Figure 1: UK GDP Growth Contributions



Source: ONS

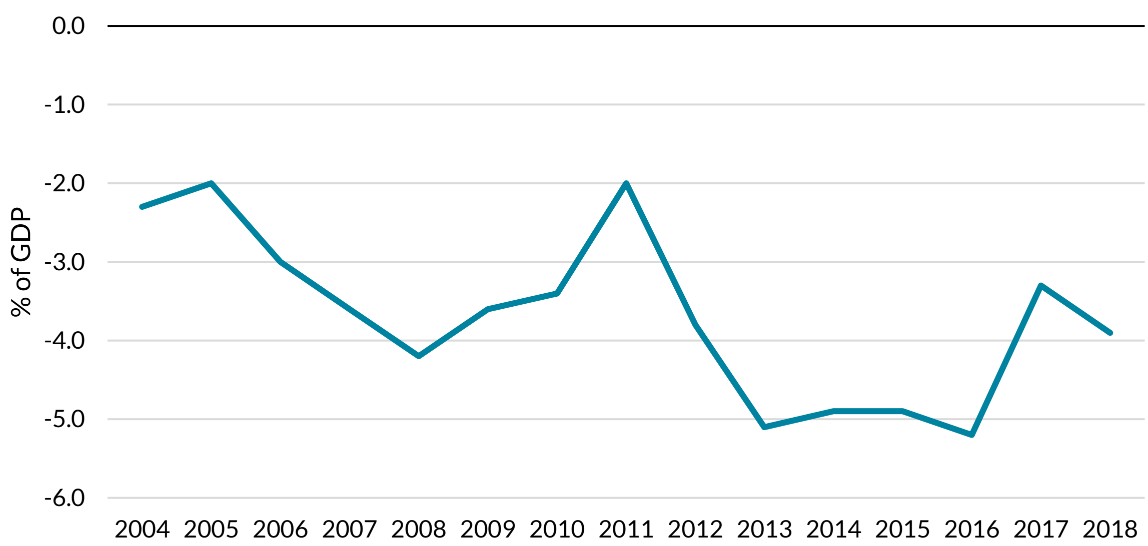
As illustrated in Figure 1, there were a number of unusual developments in the most recent UK National Accounts data which are for Q1 2019 (far right hand-side column). Firstly, the contribution of stockbuilding (green columns) to overall UK growth, which has been increasing from mid 2018, spiked in Q1 2019. In the quarter, stocks contributed 2.6 percentage points to annual UK GDP growth. The substantial boost to growth from stockbuilding is likely to be temporary as it reflected precautionary activity by firms to accumulate stocks in advance of the initial 31 March 2019 deadline for the UK to exit the EU. Secondly, the contribution to growth from net exports (orange column) declined sharply in the first quarter while the domestic demand contribution increased (dark blue column). The decline in net exports was mainly driven by stronger imports (linked to the rise in stocks) along with an increase in imports of non-monetary gold. The latter has a neutral effect on overall GDP because the rise in imports (which reduces GDP) is offset by an increase in gross capital formation (which increases GDP).

Figure 2a: UK Trade and Exchange Rate Data



Source: ONS

Figure 2b: Balance of Payments, % of GDP



Source: ONS.

Looking in more detail at the performance of the external side of the UK economy, the sharp slowdown in UK exports (orange line) from mid 2017 is evident in Figure 2a. With import growth still positive this means that net exports are no longer making a positive contribution to overall growth. The dwindling contribution of UK exports to GDP growth is consistent with recent evidence from the literature which shows that UK firms have already started to pull back from EU-orientated export strategies, in anticipation of future trade barriers. [2] The relatively weak performance of net exports partly explains the widening of the deficit on the current account of the Balance of Payments in 2018. A large current account deficit leaves the UK economy exposed in the event of a deterioration in international financial markets, a risk highlighted by the Bank of England and the IMF in recent years (Figure 2b).[3]

UK domestic demand and its main components are shown in Figure 3a. A slowdown in overall UK domestic demand is clearly evident from late 2017 and has become more pronounced over recent quarters. As illustrated in the chart, the weakness in domestic demand is being driven by a sharp decline in business investment. In contrast, consumer spending has been more resilient, supported by a combination of strong employment growth, a pick-up in wages and low UK inflation. Another development that has helped to sustain UK consumer spending has been credit growth and a fall in the household savings rate. This has declined sharply since the 2016 referendum from 9.4 per cent in 2015 to 4.2 per cent in 2018. While the fall in the savings rate has helped to sustain consumer spending since 2016, the current very low level of household savings diminishes the resilience of consumers to shocks and could result in a decline in consumption in future quarters.

Regarding the fall in business investment, there is evidence that uncertainty over the outcome of the Brexit negotiations is weighing on UK firms' investment spending. As noted by the Bank of England (2019a), the UK decision to leave the EU in 2016 created uncertainty across several dimensions: for example, around what the UK's eventual relationship with the EU will look like and how this will affect UK firms' access to the EU market, the availability of migrant labour and product regulation. [4] There is also uncertainty around how the UK will transition to the future new arrangement with the EU and what this will mean for the prospects of individual businesses.

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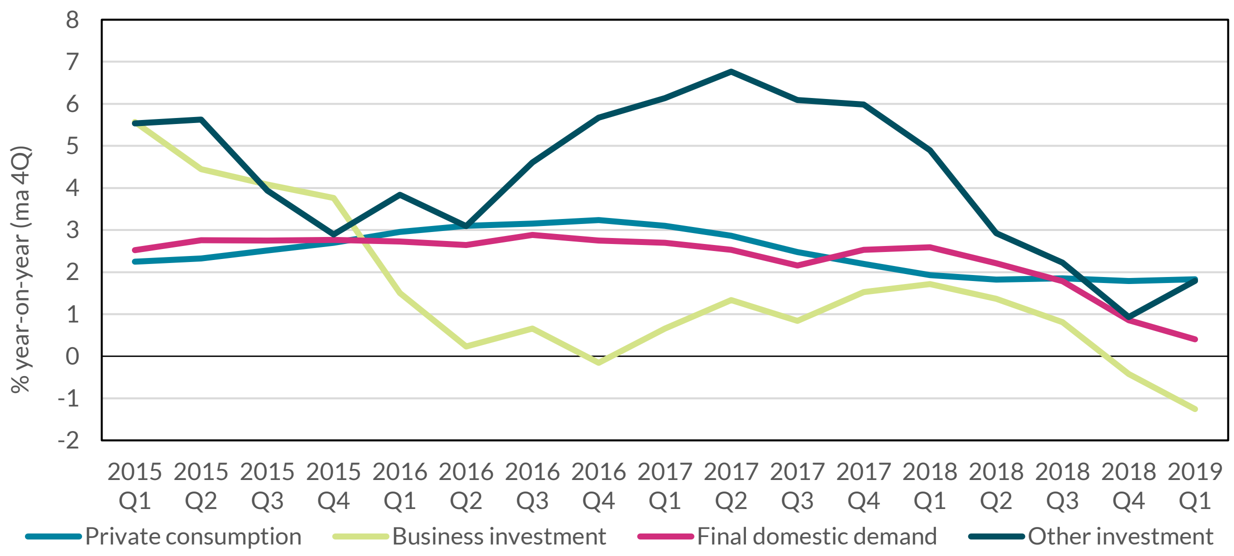
[2] See Crowley, Meredith, Oliver Exton and Lu Han (2018), "Renegotiation of Trade Agreements and Firm Exporting Decisions: Evidence from the Impact of Brexit on UK Exports," CEPR Discussion Paper 13446 and Douch, Mustapha, Edwards T. Huw and Christian Soegaard (2018), "The Trade Effects of the Brexit Announcement Shock," The Warwick Economics Research Paper Series 1176.

[3] See Bank of England (2018), "Financial Stability Report," November 2018. Available at: https://www.bankofengland.co.uk/-/media/boe/files/financial-stability-report/2018/november-2018.pdf?la=en&hash=A9AE16F96F1F4C01B9ECF1C2B4D902E9472085B3
and IMF (2018), "Article IV Consultation," Available at: https://www.imf.org/en/Publications/CR/Issues/2018/11/14/United-Kingdom-2018-Article-IV-Consultation-Press-Release-Staff-Report-Staff-Statement-and-46353

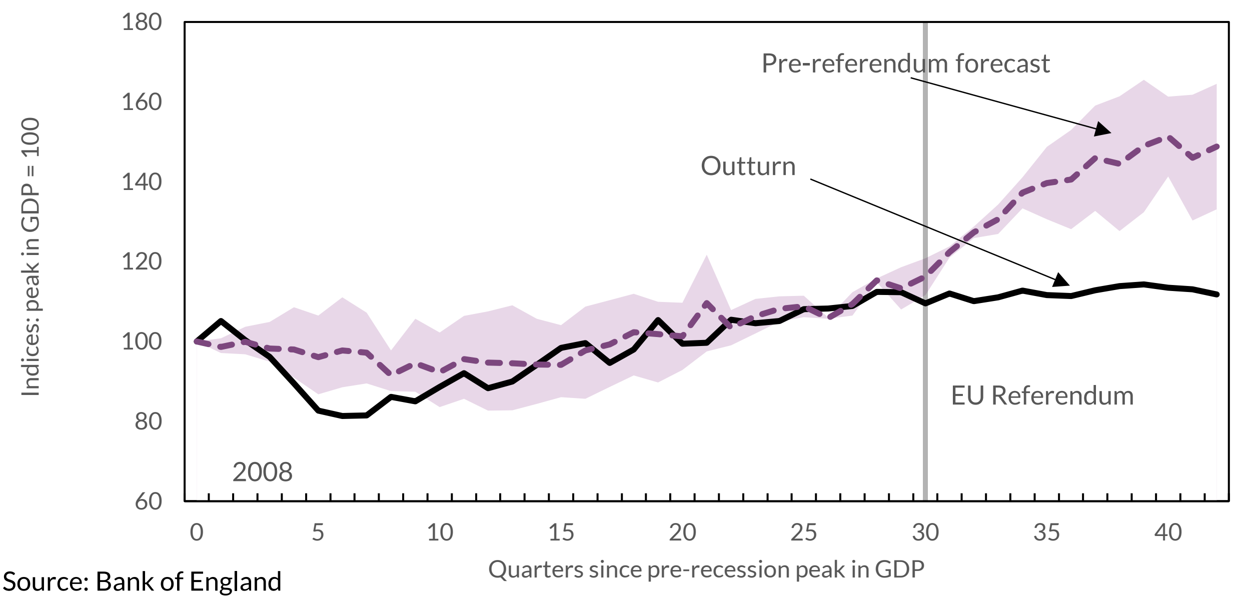
[4] See Bloom, Nicholas, Philip Bunn, Scarlet Chen, Paul Mizen, Pawel Smietanka, Greg Thwaites and Garry Young (2019a), "Brexit and uncertainty: insights from the Decision Maker Panel," Bank of England Staff Working Paper No. 780. Available at: https://www.bankofengland.co.uk/working-paper/2019/brexit-and-uncertainty-insights-from-the-decision-maker-panel

Figure 3a: UK Domestic Demand



Source: ONS

Figure 3b: UK Business Investment



Source: Bank of England

To help better understand the uncertainties created by Brexit and how they have affected UK businesses, the Bank of England launched a new survey (the Decision Maker Panel) in 2016. The results of this survey show that Brexit has provided a major and persistent uncertainty shock for UK businesses. In the two years after the 2016 referendum, Brexit was reported to be one of the top three sources of uncertainty for 40 per cent of UK firms, and this proportion increased further in Autumn 2018. There is clear evidence that the more uncertain economic environment created by Brexit has contributed to weak business investment. The Bank of England (2019b) has compared the actual performance of UK business investment to the predicted performance prior to the Brexit referendum. The results of this exercise show that UK business investment at the end of 2018 was a cumulative 18 per cent lower than the final forecast prior to the referendum (Figure 3b).

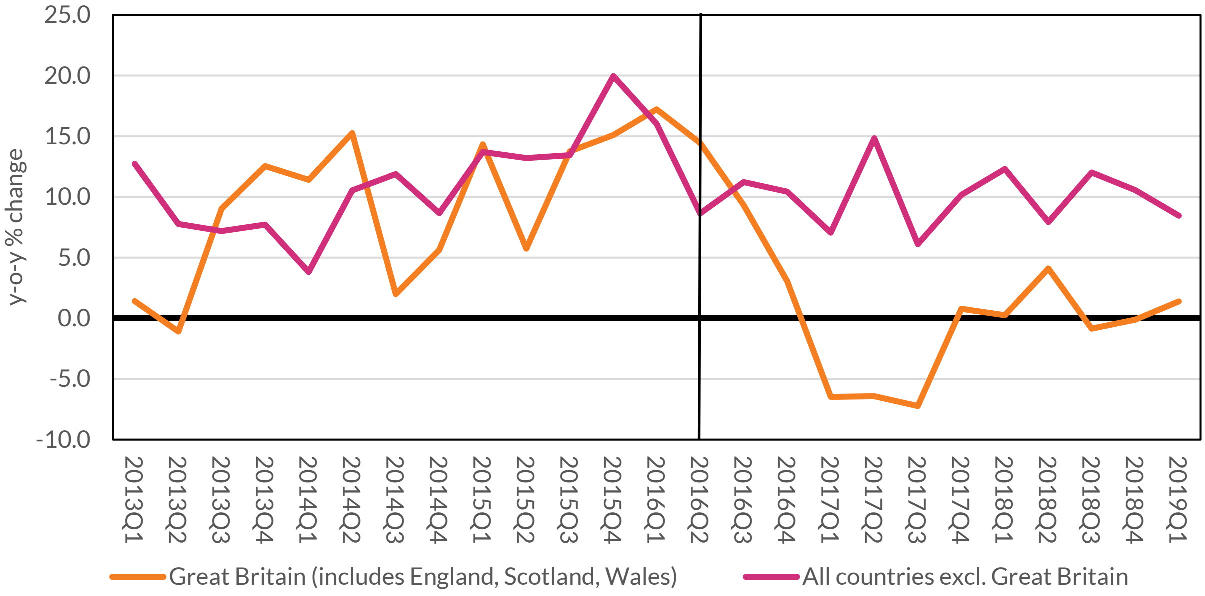
Implications for the Irish Economy

Taken together, the range of indicators discussed above provide evidence of a slowdown in UK economic activity since the EU referendum in 2016. In the case of business investment, there is clear-cut evidence that the decline is linked to Brexit-related uncertainty. There is also plausible evidence that some of the deterioration in the UK's trade performance is linked to adverse Brexit-related effects on firms' export strategies. It is difficult to quantify with precision how much lower UK growth has been relative to the outturn that would have been achieved had the UK not voted to leave the EU in 2016. This is because of the multitude of factors that affect the performance of an economy over time. Despite this, a number of studies have attempted to estimate the scale of the loss in UK GDP since the referendum result. Combining the different effects on net exports and domestic demand, one estimate from Centre for European Reform shows that by the end of 2018 the UK economy was 2½ per cent smaller than it would have been had the UK voted to remain in the EU.

What can we conclude about the possible implications of these developments for the Irish economy? With 14 per cent of all Irish exports sold to the UK, it is at least possible to say that the more sluggish UK growth will have transmitted to Ireland via lower growth in Irish economic activity, because of reduced UK demand. Although the economy has grown strongly since 2016, it follows that the rate of growth would have been higher had the UK economy not experienced the slowdown evident after the 2016 referendum.

With the available data, it is difficult to identify with certainty particular sectors or areas of economic activity where this negative effect has clearly manifested. Nevertheless, there is suggestive evidence in some areas of Brexit-related effects. For instance, looking at the composition of trade, 14 per cent of all Irish goods exports are in the category "machinery and transport equipment". The total value of these exports in 2018 amounted to €19.9 billion, of which €2.2 billion or 11 per cent went to the UK. The commodities exported in this category include investment goods such as general industrial machinery, office machines and electrical machinery. The sharp slowdown in UK investment since the 2016 referendum is likely to have reduced Irish exports in these sectors. The data provide preliminary evidence consistent with such a development. From 2011-2015, the value of Irish exports of machinery and equipment to the UK grew at an annual average rate of just over 13 per cent; the equivalent figure from 2016-2018 was -6.5 per cent per year. These data on sectoral trade flows with the UK are in value terms and therefore include the impact of exchange rate movements. Eurostat provide some data on Irish trade volumes (by weight) with the UK. These data also point to weaker growth in exports of machinery and equipment since 2016 than observed from 2011 up to the EU referendum.

Figure 4: Overseas Visitors to Ireland from Great Britain and Rest of the World, annual % change



Source: CSO

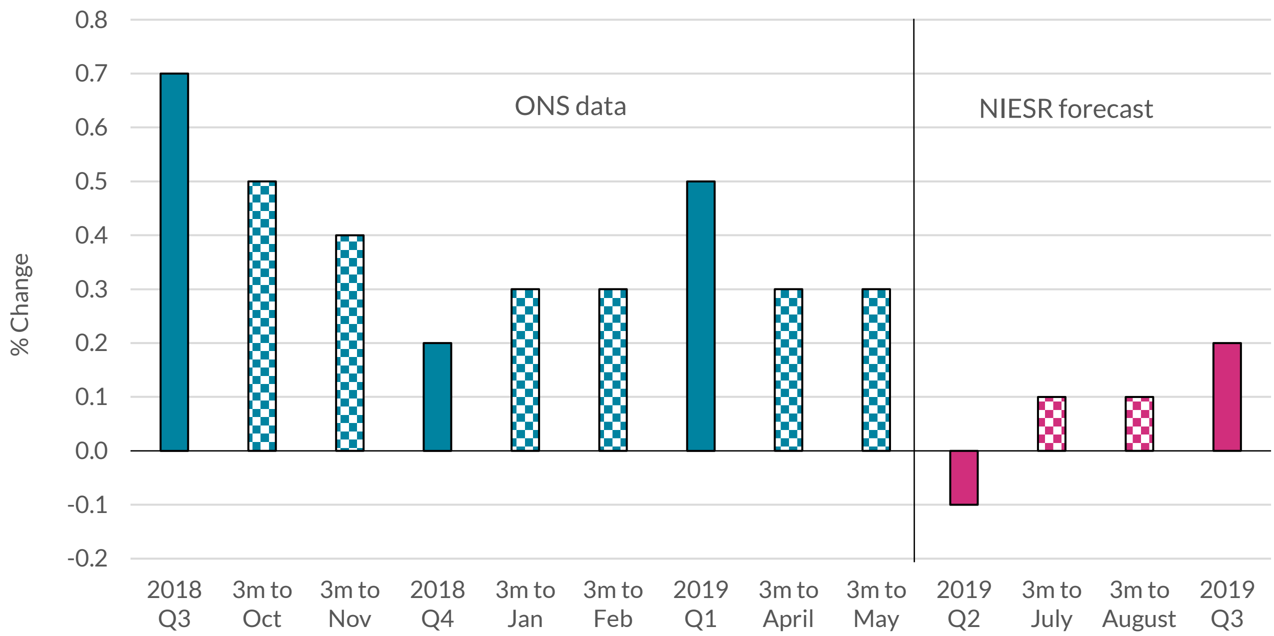
Another sector where Brexit effects appear to have already materialised is tourism and travel. Great Britain (GB) is a key tourist market for Ireland, accounting for two out of every five visitors to Ireland in 2018. There has been a sharp slowdown in the number of overseas visitors from Great Britain to Ireland since mid 2016. From Q1 2013 until Q2 2016, the number of visits to Ireland by UK residents increased at an annual average rate of just under 10 per cent; the equivalent figure for the period Q3 2016 up to Q1 2019 was -0.2 per cent. The pronounced slowdown in visitor numbers from GB residents from mid 2016 is not evident in the data for other markets. As shown in Figure 4, the total number of trips to Ireland from rest of the world residents (excluding GB) has grown at an annual average rate of just over 10 per cent since Q2 2016, in contrast to the -0.2 per cent figure for visits of UK residents. It is likely that the depreciation of sterling which reduces the purchasing power of UK households has been a contributed to the weaker growth in UK visitor numbers since 2016.

The agri-food sector is frequently cited as one of the parts of the economy most exposed to Brexit due to the high share of the sector's exports that go to the UK. Looking at the CSO data on exports of Irish agri-food products to the UK since 2016 provides mixed evidence as to the extent of Brexit-related effects. There was a noticeable drop in the value of overall agri-food exports to the UK in 2016 of 6.3 per cent. In the same year, the value of exports to the rest of the world excluding the UK increased by 9.4 per cent. The depreciation of Sterling in the lead up to and following the Brexit referendum is likely to have been a contributory factor. In 2017 and 2018, the value of agri-food exports to the UK increased by 9.2 and 3.1 per cent respectively, pointing to some recovery in trade following the poor performance in 2016.

There is also some evidence of Brexit effects in soft data releases for Ireland. Consumer sentiment has weakened since September 2018 and in April 2019 was 16.3 per cent lower than the level a year earlier. Irish consumers' more pessimistic views of both current economic conditions and the outlook may in part reflect concern over the effect of Brexit on their future employment and income prospects. The AIB Purchasing Managers Index (PMI) provides a monthly gauge of activity in the manufacturing and services sectors. The most recent PMI release for June 2019 points to a slowdown in both sectors, continuing a downward trend in evidence since autumn 2018. Within the manufacturing sector, the data on new orders have been particularly weak. Firms who responded to the survey attributed the decline in new business to a deterioration in demand and ongoing Brexit uncertainty. The soft data on sentiment and the PMI releases are sometimes useful leading indicators of consumer spending, investment and export volumes. As a result, it is possible that the subdued trends evident in these measures will be reflected in more sluggish economic growth in the coming quarters, especially if there is an increase in uncertainty in the lead up to the 31 October Brexit deadline.

Looking more broadly, the rate of change in UK imports is an important determinant of the level of demand for Irish exports. The annual average growth in UK imports from Q1 2012 to Q4 2015 was 3.9 per cent; the figure for the period Q1 2016 up to Q3 2018 was almost 1½ percentage points lower at 2.5 per cent. The reduction in UK import growth will have directly reduced the demand for Irish exports across many sectors. Although the declining trend in imports was reversed in Q1 2019, this is likely to have been a temporary surge, linked to the increase in stock building.

Figure 5: UK GDP Growth, 3 month-on-3 month % Change



Source: NIESR, ONS

Lastly, recent economic data for the UK have been particularly weak and point to a pronounced slowdown in activity since the end of the first quarter. The UK ONS publish estimates of monthly GDP. According to the latest data, UK GDP was flat in March and contracted in April by 0.4 per cent. It is likely that the weak outturn reflects a combination of developments, with ongoing Brexit-related uncertainty and global trade tensions acting as a drag on investment spending and growth.

Figure 5 shows the realised outturn for UK GDP growth up to Q1 2019, as well as forecasts for Q2 compiled by the National Institute in the UK based on these data. The latest NIESR estimate indicates that the UK economy is on course to contract by 0.1 per cent in the second quarter of 2019, a marked slowdown from the first quarter when growth was boosted by temporary stockbuilding. Although growth is expected to recover somewhat in Q3 2019, at 0.2 per cent, the projected rate of expansion is feeble and well below the rate of growth in recent previous quarters. If the weakness in the UK economy in Q2 materialises and persists into Q3, this would represent a significant deterioration in the external environment and could result in a downgrading in the outlook for the Irish economy in 2019 compared to the projections in the Bulletin.

In conclusion, the research published by the Central Bank and others shows that all versions of Brexit will result in the Irish economy being smaller than it would have been had the UK remained an EU member, with a disorderly no-deal Brexit resulting in the largest loss of output. The analysis presented here indicates that even before Brexit has taken place, the UK decision to leave the EU has had a negative effect on the Irish economy.