Banc Ceannais na hÉireann
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Box D: QB 1 – March 2023

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Implications of Weaker UK Economic Growth for the Irish Economy

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UK economic growth has been weak in recent years relative to Ireland's other main trading partners, even allowing for common shocks such as the pandemic and the Russia-Ukraine war. According to the latest IMF projections, the UK is at risk of falling into recession in 2023, the only major G7 economy where this is projected to occur.[2] Looking beyond 2023, the UK is expected to grow at a lower rate when compared to both historical standards and the latest growth projections for other developed economies. This Box looks at the implication of this lower UK growth outlook for the Irish economy as well as the relative importance of the underlying drivers behind the UK outlook.

Despite a long-run downward trend in the UK share of Irish trade, the UK remains one of Ireland's key trading partners along with the US and euro area (Table A). Consequently, developments in the UK economy remain relatively important for Ireland.[3]

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[1] Irish Economic Analysis Division.
[2] https://www.imf.org/en/Publications/WEO/Issues/2023/01/31/world-economic-outlook-update-january-2023
[3] Box A of the Financial Stability Review II 2022 discusses the main spillover channels from the UK to the Irish economy and financial system.

Table A: Ireland's main trading partners

	Goods				Services			
RANK	Top 10 importing partners 2021	% of total imports	Top 10 exporting partners 2021	% of total exports	Top 10 importing partners 2021	% of total imports	Top 10 exporting partners 2021	% of total exports
1	**UK**	**19**	US	32	US	14	US	49
2	US	17	**UK**	**11**	**UK**	**13.7**	**UK**	**8**
3	France	10	Germany	11	Germany	7	Netherlands	4
4	China	8	Belgium	8	Netherlands	4	Singapore	3
5	Germany	7	China	7	Japan	4	Switzerland	2
6	Switzerland	5	Netherlands	6	France	4	Germany	2
7	Netherlands	4	France	3	China	3	Belgium	2
8	Israel	2	Italy	3	Italy	3	China	2
9	Belgium	2	Switzerland	2	Australia	3	France	2
10	Italy	2	Japan	2	Switzerland	2	Italy	1

Source: CSO TSA02, BPA05.

The longer-term outlook for UK GDP growth has been on a downward trend since 2016, with the latest projections from the National Institute of Economic and Social Research (NIESR) suggesting that the UK economy will grow by less than 1.4 per cent per annum on average until the end of the decade (Figure 1). This compares to earlier projections from 2016 and 2017 in which the UK economy was expected to grow by around 2 per cent over the long term.

UK GDP growth projections for 2023-2029 have been revised downwards over time

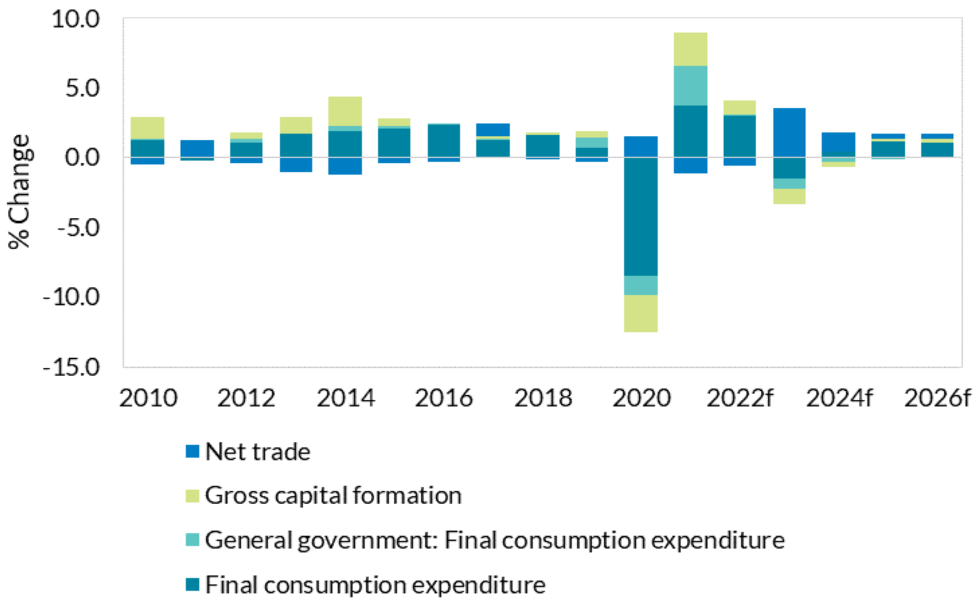
Figure 1: Average GDP growth projection for 2023-2029

Source: ONS and NIESR.

Figure 2 shows the historical and projected contributions to UK GDP growth over the period 2010-2026.[4] Domestic demand has been a key driver of growth for the UK economy over the period 2010 to 2019, however, the near term projection by NIESR suggests that domestic demand will provide a negative contribution out to 2025 before returning to growth thereafter, albeit at a historically lower rate.

Contributions to UK GDP growth and long-run projections

Figure 2: Historical and projected contributions to UK GDP growth



Source: ONS and NIESR.

Table B shows that the downward revisions to the longer-term forecasts for the UK are driven by weaker contributions to growth from domestic demand. For example, in the latest NIESR forecast, private consumption, investment, and government consumption, are expected to contribute 0.6, 0.03 and 0.3 percentage points to UK growth over the long-run. This compares to earlier forecasts in which these components of domestic demand made significantly higher contributions to growth of 2.2, 1.3 and 2.7 percentage points, respectively (see Table B).

[4] The projected data is taken from the latest NIESR UK Economic Outlook (January 2023), Series A. No. 9.

Table B: Decomposition of UK GDP forecasts (averages for 2023-2029 period)

	NIESR April 2016 Forecast	NIESR February 2023 Forecast	Deviation
Private consumption	2.2	0.6	-1.6
Gov. consumption	2.7	0.3	-2.4
Investment	1.3	0	-1.3
Exports	2.4	2.6	0.2
Imports	2.4	-0.5	-2.9
GDP	2.1	1.3	-0.8
Source: NIESR and NIGEM model databases.			

The impact of this slower annual growth means that by the end of the decade the level of UK GDP is expected to be around 5.4 per cent lower than anticipated in the projections made in 2016. The implication of this lower UK GDP growth for the Irish economy is an estimated reduced level of output of close to 2 per cent by 2029, relative to what would have been expected based on the 2016 forecasts. In the next section, we show that the Irish output response to a range of UK domestic and external shocks is greatest when the source of the shock is UK private consumption. As shown in Table B, the outlook for UK consumption has already been revised down over recent years and it is currently one of the main risks to the UK growth outlook.[5]

Risks to the UK outlook

The UK economy is facing several headwinds. Negative real disposable income in 2022 has eroded households' purchasing power and reduced consumption. Since 2016, business investment growth has been flat leading to a reduction in the productive capacity of the UK economy. The Bank of England has calculated that the drop in UK business investment has resulted in a productivity gap to the tune of £29 billion (1.3 per cent of GDP) since 2016.[6] In their most recent assessment of the UK economy, NIESR stated that the main threats to the UK outlook are the tightening of households' disposable income bearing down further on consumption and increasing borrowing costs for business leading to sustained weak business investment.

Trade has also been adversely affected with challenges importing capital and intermediate goods adding further reducing the productive capacity of the economy. As noted by the OBR, the UK appears

[5] A standard BVAR analysis of external shocks to the Irish economy suggests that a 1 standard deviation shock to UK GDP growth translates into a 0.7 per cent reduction in Irish GDP growth. Similar results of 0.8 and 0.5 per cent are found in Bermingham and Conefrey (2011) and O'Grady, Rice, and Walsh (2017), respectively.
[6] See interview with Bank of England MPC member Johnathan Haskell: theovershoot.co/p/the-bank-of-englands-jonathan-haskel (13 February 2023).

to have become a less trade intensive economy, with trade as a share of GDP falling 12 per cent since 2019, two and a half times more than in any other G7 country.

The monetary and fiscal outlook is also challenging. To bring down high inflation, the Bank of England increased interest rates for the 10th consecutive time in February 2023, bringing the policy rate to 4 per cent. The MPC noted how the intensification of domestic price and wage pressures, alongside the reduction in the productive capacity of the UK economy, have increased risks of inflationary persistence. The Bank also stated that there is a possibility of further tightening which will weigh on economic growth.

Although conditions have stabilised following the turmoil in the aftermath of the autumn 2022 mini budget, in their November 2022 assessment, the OBR stated the UK's medium-term fiscal outlook has materially worsened since March 2022 due to a weaker economy, higher interest rates and higher inflation.[7]

The current forecasts for the UK economy incorporate the estimated likely effects of these headwinds, however, there is a risk of further downgrades to the UK growth outlook as a result of these significant challenges. To help understand the implication of these risks to the UK's growth outlook for the Irish economy, we simulate a number of shocks to the UK economy using the NiGEM model.[8] We then investigate the spillovers from the UK to the Irish economy using the Central Bank's the structural macroeconometric model.[9] The set of shocks that we examine are standardised to produce a 1 per cent reduction in UK GDP and are chosen to be consistent with the UK risk narrative outlined above. The five UK shocked variables that we consider are: government consumption, private consumption, business investment, equity prices, and foreign demand.

Each of these adverse shocks to the UK economy would lead to a reduction in economic activity in Ireland. The decline in economic activity would also have fiscal implications in terms of reduced tax revenues and higher spending due to automatic stabilisers.

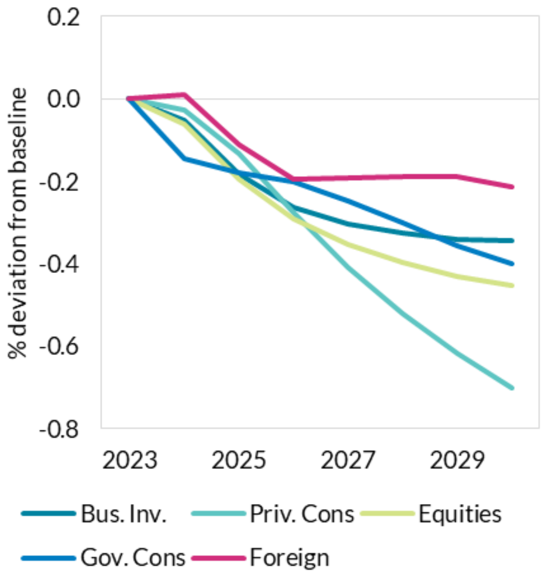
Figures 3 and 4 show the impact of the shocks on output and employment in the Irish economy. The relative magnitude of the impact of the UK shocks on the Irish economy is dependent on a number of factors (i) the import content of each of the shocked variables, (ii) the subsequent impact on the foreign demand for Irish exports, and (iii) the endogenous response of the UK economy to each of the shocks. The shock to UK private consumption (red) has the largest long-run impact on the Irish economy, owing to its relatively high import content and long-run impact on the demand for Irish exports, reducing Irish

[7] OBR Economic and fiscal outlook – November 2022.
[8] NiGEM is a global economic model developed by the National Institute of Economic and Social Research in the UK.
[9] We use the Bank's own version of the COSMO model of the Irish economy (see Bergin et al (2017) and Conefrey, O'Reilly and Walsh (2018)).

output and employment by 0.7 and 0.5 per cent, respectively, by 2030. In the simulations, the other UK domestic shocks to equity prices (green), business investment (blue), and government consumption (purple), would each reduce Irish output and employment in the long-run by about 0.4 and 0.3 per cent, respectively. The UK foreign demand shock (light blue) reduces Irish output and employment by 0.2 per cent in the long-run, which is roughly in line with the share of UK demand for Irish exports.

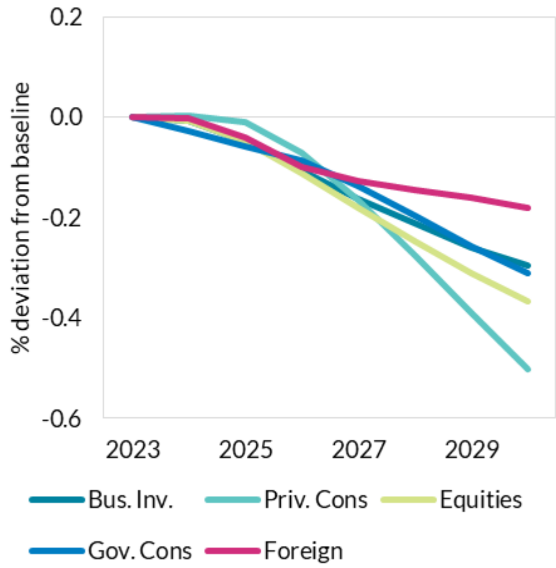
UK shocks impact on Irish economy

Figure 3: Irish output response to UK shocks (% deviation from baseline)



Source: author's calculations.

Figure 4: Irish employment response to UK shocks (% deviation from baseline)



Source: author's calculations

Despite the decline in Ireland-UK trade linkages over time and the structural change that has occurred with the UK leaving the European Union, the UK economy remains a key trading partner for Ireland. Projections for the UK economy out to the end of the decade have been revised down consistently over recent years and point to more subdued growth than has been observed historically over the last 50 years. This Box has outlined how the weaker UK growth outlook will reduce activity in the Irish economy. Moreover, there is the potential for further negative spillovers to the Irish economy if the outlook for UK growth was to deteriorate further. The magnitude of the effect on the Irish economy would depend on the source of the shock, or combination of shocks, to UK growth with negative shocks to UK domestic demand having the largest impact on the Irish economy.