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Risks Facing the Irish Economy at the End of the Brexit Transition Period

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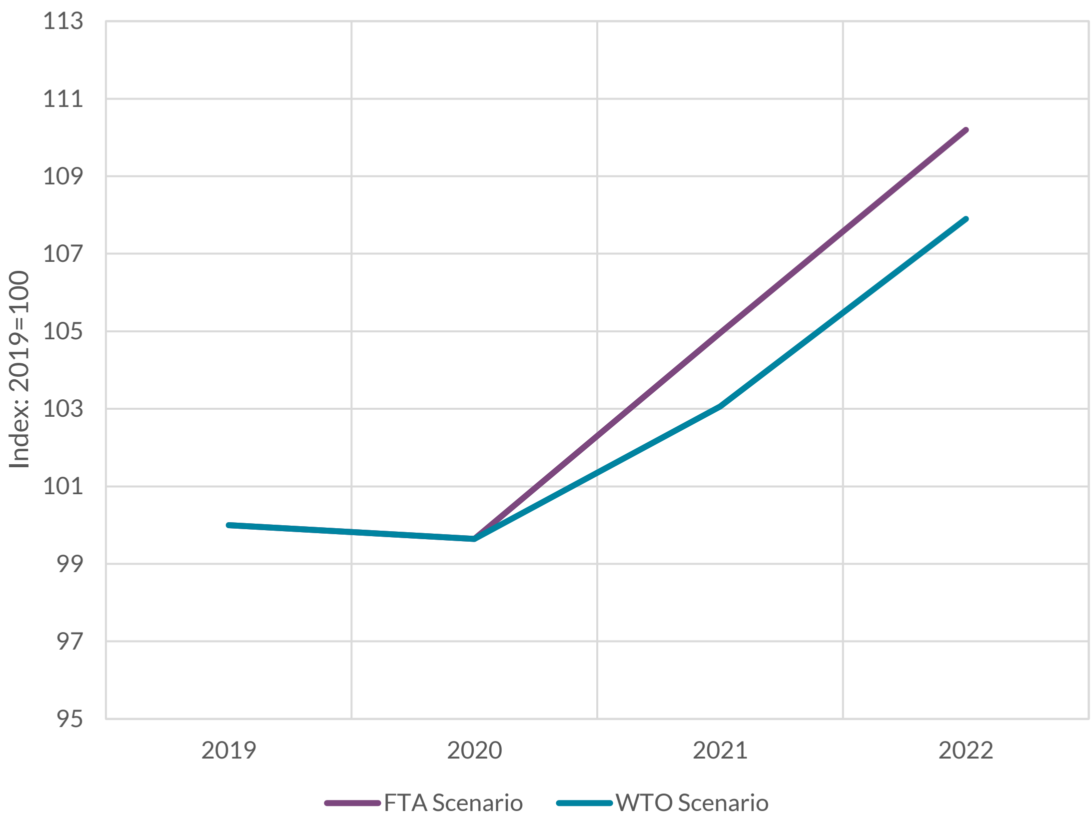
When the transition period ends on 31 December 2020, EU-UK trade will face new frictions, irrespective of whether a trade deal is reached. This Box outlines some of the risks to the Irish economy from the change in EU-UK trading arrangements that will occur on 1 January. Aside from the imposition of tariffs which would occur in a WTO outcome, other non-tariff restrictions will make trading with the UK more difficult for Irish businesses and these frictions will arise even if a free trade deal is agreed.

The projections in this *Quarterly Bulletin* are based on the assumption that the EU and UK move to trading on WTO terms from 1 January 2021. In overall terms, our model-based estimates – embedded in our projections – suggest that moving to WTO terms could reduce the growth rate of the Irish economy by around 2 percentage points in 2021, relative to a scenario where a Free Trade Agreement was concluded (Figure 1).[2] It is important to note that there is considerable uncertainty around aggregate estimates of the impact on the economy of a WTO or FTA outcome given the unprecedented change in trading arrangements that will take place from January 2021. Regardless of whether a FTA is reached before December, from January the UK will no longer apply the rules of the European Union, the Single Market or the Customs Union which will unavoidably lead to new trade frictions. In this Box we provide a brief outline of some of the particular challenges that will arise for importers and exporters under a WTO or FTA arrangement.

[1] The authors would like to thank Gina Fitzgerald and Cian Murphy (Central Bank) for helpful comments on this box.

[2] See Conefrey, T. and G. Walsh. 2020. "Implications of Potential EU-UK Trade Arrangements at the End of the Brexit Transition Period." Quarterly Bulletin 3 Box D. Available at: https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/boxes/qb3-2020/box-d-implications-of-potential-eu-uk-trade-arrangements-at-the-end-of-brexit-transition-period.pdf

Figure 1: GDP in a disruptive WTO scenario and Free Trade Agreement scenario (2019=100)



Source: CBI calculations.

Trading on WTO Terms

If the UK and EU do not agree a new trade deal, then trade would revert to rules governed by WTO terms. A free trade agreement represents one of the only exemptions to the WTO's "Most Favoured Nation" (MFN) clause. [3] MFN means that every time a country lowers a trade barrier or opens up a market, it must do so for the same goods or services from all its trading partners. Accordingly, imported British goods would be charged tariffs according to the EU's Most Favoured Nation (MFN) terms and vice versa. In the case of cars, for example, there would be a 10 per cent tariff on imports into the EU. The UK set out its proposed tariff schedule to the WTO in 2018. In May 2020, it announced a new "UK global tariff" that eliminates a number of low tariffs, but leaves others in place on goods such as cars and ceramics and on many agricultural goods.[4] These tariffs would apply to UK

[3] The description of the MFN principle is the first article of the 1947 General Agreement on Tariffs and Trade (GATT).
[4] See https://www.gov.uk/check-tariffs-1-january-2021

imports from the EU on 1 January 2021 in the event of no trade deal. Higher tariffs typically apply to agri-food products with lower tariffs on manufactured goods. The aim of the tariffs is to protect the UK industry in these goods from cheaper imports.

Although the share of Irish goods exports to the UK has declined over time and currently stands at around 10 per cent, the agri-food sector is still heavily reliant on the UK market. In 2019, around 38 per cent of agri-food exports went to the UK. Sectors such as beef depend even more on the UK market. Estimates suggest that applying the UK's global tariff schedule to Irish exports to Great Britain would result in a tariff cost of between €1.35 to €1.5 billion.[5] The imposition of tariffs of this magnitude would substantially reduce, or possibly eliminate, Ireland-UK trade in some products. Lawless and Daly (2020) estimate that Irish exports to the UK of food products, beverages and tobacco could be reduced by 75 per cent, assuming tariffs were fully passed through to the price of products.[6] The imposition of the full range of UK tariffs across all product categories could lower overall Irish exports by around 4 per cent.

Free Trade Agreement

If a FTA is successfully concluded before the end of 2020, it should allow for tariff- and quota-free trade in goods. In this regard a FTA is an improvement relative to trading under WTO terms. While an FTA would eliminate tariffs, firms engaged in EU-UK trade would still face an extensive range of other new frictions – known as non-tariff barriers (NTBs) – than under current arrangements. These NTBs would apply in addition to tariffs in a WTO outcome and would affect both importing and exporting. Non-tariff barriers can increase the cost of doing business. NTBs may be quite specific – such as adherence to individual product standards – or more general, such as more stringent customs and documentary related procedures.

Because the UK would no longer be part of the EU customs union, exporters would need to provide proof that their products meet the "rules of origin" criteria of the EU-UK FTA. Compliance with such rules comes with complications, paperwork and cost.[7] Businesses trading between the EU and UK will be required to manage new import and export formalities, including customs and security declarations, risk-based inspections and the payment of tariffs (for any goods not covered by the FTA) and other taxes payable on import such as VAT and excise duty. Unless the UK agrees to adhere fully to the EU's sanitary and phyto-sanitary regime (for food and plant hygiene), trade in agri-food

[5] See https://www.gov.ie/en/publication/849b3-the-brexit-readiness-action-plan/
[6] See Daly, L. and M. Lawless. 2020. "Examination of the sectoral overlap of COVID-19 and Brexit shocks." ESRI Working Paper no. 677. Available at: https://www.esri.ie/system/files/publications/WP677_0.pdf
[7] See Lowe, S. 2019. "What a Boris Johnson EU-UK Free Trade Agreement means for Business." Centre for European Reform Insight. Available at: https://www.cer.eu/sites/default/files/insight_SL_5.11.19_2.pdf

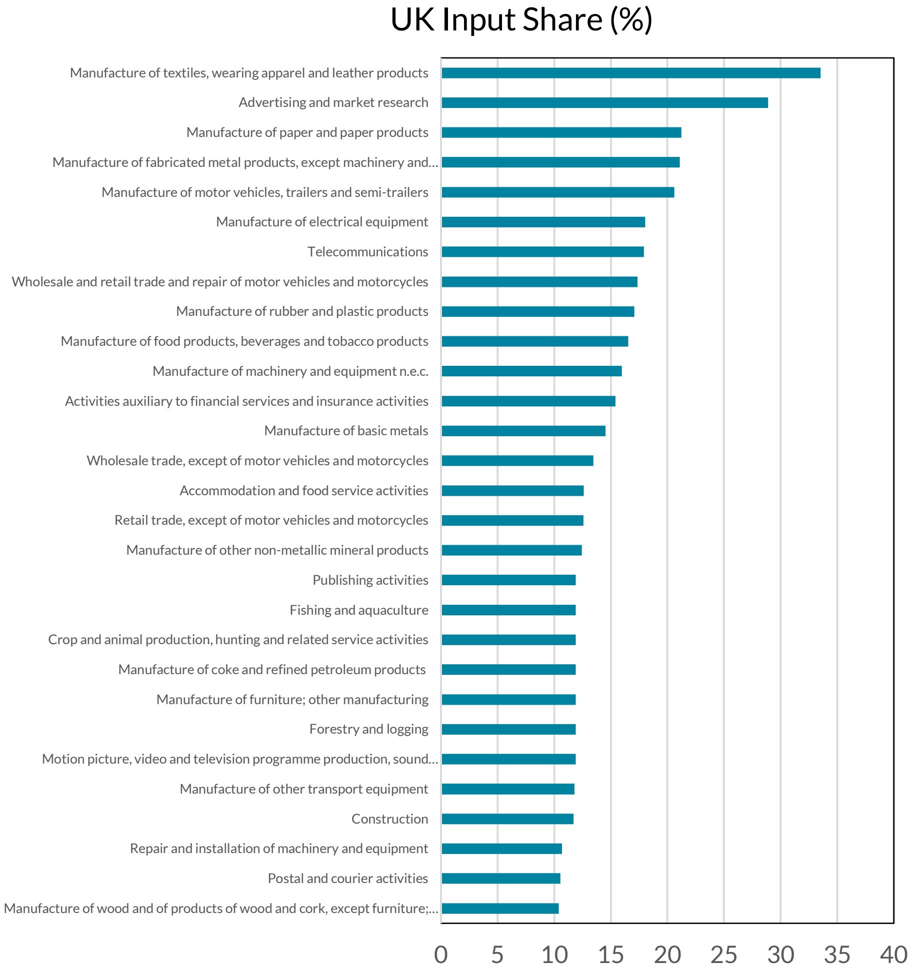
products will require export health certificates and there will be a need for veterinary border inspections.

Outside of the customs union, British importers will be exempt from adherence to EU regulatory standards on goods imports from non-EU countries. This could harm the competitiveness of exporters selling EU-compliant goods into the UK market. Second, delays associated with increased customs handling times and documentary compliance requirements will increase costs for Irish exporters. While the extent of checks at the UK border is not yet clear, the EU Union Customs Code sets out procedures required for EU exporters when exporting to a third country.[8] These procedures include declarations at point of export, outward customs arrival, outward clearance, import, inward customs arrival, and where goods consignments must be held in temporary storage. In addition, goods are required to pass UK customs inspection procedures and are likely to be subject to longer handling delays due to the increase in the volume of imports subject to such procedures.

The new non-tariff restrictions will also affect imports. In 2019, Ireland imported over €20 billion of goods from the UK, accounting for 22 per cent of the value of all goods imports. New customs procedures and delays could prove disruptive for Irish firms with supply chain linkages with the UK. Figure 2 shows the share of Irish firms' imported intermediate inputs by sector which originate in the UK as a proportion of overall imported intermediates. It shows the top 30 sectors with a UK input share of over 10 per cent. Intermediate inputs are goods or services used by a firm to produce their final output. The sector *manufacture of textiles* and *advertising and market research* sectors have the highest reliance on the UK for imported intermediates. Other sectors with a high share of imported intermediate inputs from the UK include the wholesale and retail sector and some traditional manufacturing sectors. These sectors are likely to face additional costs and delays associated with sourcing imported intermediate inputs from the UK. For firms in these sectors who use UK imports to produce other goods and services for export, higher costs could affect their international competitiveness. There could also be implications for Irish consumers if higher import costs increase the price of certain consumer goods.[9] The availability of some goods and services could also be impacted if non-tariff barriers were to severely disrupt supply chains.

[8] Regulation (EU) No 952/2013 of the European Parliament.
[9] See Horan, D., McQuade, P. and J. Scally. 2019. "Grocery Prices in Ireland after Brexit." Central Bank Quarterly Bulletin No. 4 2019. Available at: https://www.centralbank.ie/docs/default-source/publications/quarterly-bulletins/boxes/qb4-2019/box-d-grocery-prices-in-ireland-after-brexit.pdf

Figure 2: Proportion of overall imported intermediate inputs from the UK by sector, top 30 sectors



Source: World Input-Output Tables.

In relation to services trade, in 2018 Ireland's services exports to the UK amounted to €28.3 billion or 15.7 per cent of overall services exports, with varying degrees of exposure by sector. 37 per cent of financial services exports went to the UK, with 26 per cent of insurance services and 20 per cent of tourism and travel exports. 9.6 per cent (€17.8 billion) of Ireland's services imports came from the UK in 2018. Financial services, business services and insurance accounted for the majority of imports. The UK currently benefits from the ability to passport into the EU single market but will lose this access from 1 January 2021.[10]

Although the UK has established a temporary permissions regime enabling certain EEA firms and funds operating in the UK via a passport to continue their activities in the UK for a limited period after

[10] Passporting allows financial services firms, authorised to undertake activity by the regulatory body of one EU member state, to conduct the same business throughout the European Economic Area (EEA) without requiring further authorisation.

the end of the transition period, and the EU has announced a time-limited equivalence decision[11] for UK-based central counterparties (CCPs) to continue to operate in the EU until the middle of 2022, in the longer term the loss of passporting rights is likely to have negative implications for Ireland-UK trade in financial services.

The future trading relationship between the UK and the EU in relation to financial services will depend, in part, on the approach taken to granting UK-based firms access to the EU Single Market via equivalence decisions; but also on various EU initiatives to enhance the capacity and functioning of the EU financial sector, for instance the recently-published Capital Markets Union Action Plan from the EU Commission.[12] The level of disruption to cross-border financial services will also depend on the future level of regulatory alignment between the EU and UK frameworks.

More broadly, the EU's regime for the free movement of services is much more comprehensive than would exist under a FTA or WTO regime. In the EU, there is an extensive programme of mutual recognition of qualifications making it much easier to provide different types of services across borders. If EU and UK regulations diverge over time, this could create new regulatory barriers to services trade. In addition, recent research has demonstrated important interlinkages between goods and services trade whereby large amounts of services trade is generated by the activities of firms in the manufacturing sector who export goods.[13] This bundling of goods and services trade in Global Value Chains (GVCs) could amplify the overall economic impact of any new disruption to goods trade after the end of the transition period.

The negative effects on Ireland-UK trade through the channels discussed above could be mitigated if Brexit results in an increase in FDI inflows into Ireland. This could materialise either from the diversion of some existing UK FDI to Ireland or by attracting new FDI to Ireland that would otherwise have been destined for the UK. Since 2016, there has been some relocation of activities from London to Dublin in the financial services sector.

Landbridge

The UK landbridge describes the route that connects Irish importers and exporters to the EU single market and wider international markets using the UK's road and port networks. According to the Irish Marine Development Office (IMDO, 2018), around 38 per cent of unitised Irish exports to EU continental ports transit via the UK landbridge. It is particularly important for importing and exporting bulkier goods, as well as perishable agri-food products. The landbridge provides a significantly faster route for transporting these goods to the continent compared to alternative options. The IMDO

[11] See: https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1713
[12] See: https://ec.europa.eu/commission/presscorner/detail/en/IP_20_1677
[13] See https://blogs.sussex.ac.uk/uktpo/2020/06/11/foreign-investment-as-a-stepping-stone-for-services-trade/

estimate that the landbridge route through Dublin and Calais takes approximately 20 hours, when time in port is included. Comparable direct Roll-on Roll-off services can take up to 40 hours.

The UK's decision to remain in the Common Transit Convention (CTC) at the end of the transition period means that it will still be possible to import and export goods via the landbridge; however, such movements will be subject to new checks and potential delays. The CTC allows EU goods to move under transit through the UK without undergoing full customs import and export formalities on entry and exit. To avail of the CTC, hauliers will be required to provide a financial guarantee to cover any potential VAT and customs duties and new paperwork will have to be completed.

A further concern relates to the risk of delays for Irish hauliers transporting goods through UK ports. From January 2021, British freight will be third country freight – subject to customs and regulatory controls at European ports. Unless the infrastructure at EU and British ports (for example, Dover) is capable of differentiating British and Irish freight, then Irish goods transiting through the UK en route to other EU countries could be affected by bottlenecks at UK ports as new customs and border controls are carried out on UK goods. UK customs and logistics associations have recently stated that the IT and other infrastructure that will be required to process new customs and border checks from 1 January 2021 is not yet fully operational.[14]

Conclusion

The projections in this *Bulletin* assume that the UK moves to trading on WTO terms from 1 January. Model-based estimates of the potential impact of a *disruptive WTO* scenario contained in the Bank's July *Quarterly Bulletin* are used to inform these projections. If a FTA deal can be reached, growth in 2021 and 2022 would be higher than in the baseline forecasts.

The *disruptive WTO* scenario underpinning the *baseline* projections assumes that the move to WTO terms in January 2021 leads to an increase in uncertainty and additional up-front disruption to trade flows. This Box has described some of the channels through which these effects could occur. Since the UK is the first country to leave the EU, there is a large degree of uncertainty as to the likely impact on the economy and the model estimates used in the projections capture only some of the effects. What is evident from the analysis in this Box is that – regardless of whether the outcome in January 2021 involves moving to a basic FTA or WTO terms – there is a risk of significant disruption to economic activity from 1 January 2021, particularly for firms and sectors with high exposure to the UK. To help minimise the short-term economic losses, it is important for firms (importers and exporters) and public authorities to use the time remaining to prepare for the changes in the EU-UK economic relationship that will apply from the end of the year. In the long run, it is possible that the economy will adjust to

[14] See: https://www.ft.com/content/49af99f3-4669-4654-a444-4e5e9635791c

the new economic relationship between the EU and the UK but the short-run difficulties are likely to be immense.