# Quarterly Economic Observer

Winter 2016


NERI Nevin Economic Research Institute

# About NERI and this publication

The Nevin Economic Research Institute (NERI) was established to provide information, analysis and economic policy alternatives. Named in honour of Dónal Nevin, scholar, trade unionist and socialist who gave a life of service to the common good, the Institute aims to undertake research that will be of relevance to the Trade Union movement and the general public across the island of Ireland.

This is the 20th *Quarterly Economic Observer* (QEO) of the Institute. The purpose of the QEO is to provide regular, accessible and timely commentary so as to equip trade unions and others in articulating and advancing a new economic paradigm where the old has failed. Unless otherwise stated, the data cited in this Observer are the latest available as of late November 2016. The final draft of this document was completed on the 1st of December 2016.

This report has been prepared by staff of the Institute. The lead author of the QEO is Paul Mac Flynn. We are grateful to two external reviewers from the academic and research community who reviewed and commented on an earlier draft of this document. The analyses and views expressed in this publication are those of the NERI and do not necessarily reflect those of others including the Irish Congress of Trade Unions or the unions supporting the work of the Institute.

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# The Nevin Economic Research Institute

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# Executive Summary

This edition of the NERI's *Quarterly Economic Observer* (QEO) outlines our assessment of the economic prospects for both Northern Ireland and the Republic of Ireland (Section 1) and provides an examination of the potential impacts of a 'Hard BREXIT' on the Northern Ireland economy (Section 2).

***Economic Outlook for Northern Ireland***

- There is little indication of any slow-down in the UK economy post referendum and the prospects for the Northern Ireland economy in the very short-term look reasonably stable. There have been no official output statistics for Northern Ireland since the referendum but unofficial estimates would indicate that if BREXIT uncertainty has had an impact, it was limited in the short run. How the economy will fare once the BREXIT process is actually underway is much less clear.
- The construction sector has been the predominant driver of output growth in the first half of 2016, but employment statistics would indicate that much of this activity is generated by the activity of Northern Ireland firms in Great Britain.
- The performance of the Northern Ireland labour market over the summer months has been positive with the employment rate reaching over 74%. Whilst the longer-term impacts of BREXIT are still to come; the depreciation of Sterling is likely to have boosted cross-border trade and employment in retail and hospitality.
- There are however some more troubling trends emerging in the labour market particularly with regard to age and gender. The increase in male unemployment may be linked to the upsurge in redundancies within the manufacturing sector, whilst the increase in youth unemployment is a worrying reversal.
- The UK government's Autumn Statement was delivered in the context of a significant downgrade to the OBR's projections for the UK economy. Whilst there will be a small investment boost for the NI Executive, the overall fiscal adjustment from the last Spending Review is unchanged, and this will pose a significant challenge for the NI economy over the next five years.

- Further reductions to the UK corporation tax rate along with policy statements from the incoming Trump administration put the efficacy of the NI Executive's corporation tax policy into serious doubt. This policy should be abandoned and fiscal resources prioritised elsewhere.

***Outlook for the Republic of Ireland***

- Growth in output in 2016 has been strong particularly with regard to domestic demand and personal consumption. Whilst the labour market continues to perform well, wages have yet to match the performance of employment.
- Despite significant reductions, government debt remains elevated and this could raise concerns in light of revenue vulnerabilities particularly with regard to corporation tax.
- Budget 2017 made modest use of the fiscal space available to the government and while policies announcements on childcare and aggressive tax avoidance were welcome, the cuts to capital acquisitions taxes and policies to boost housing demand were particularly imprudent.
- Overall we forecast that unemployment will continue to fall but the rate of growth in output will start to slow in 2017.

***The Implications of a Hard BREXIT for the Northern Ireland Economy***

- The increasing likelihood of a 'Hard BREXIT' is already having an impact on the Northern Ireland economy through the significant reduction in the value of Sterling. This will feed into domestic inflation which we expect to increase to 2.7% by the middle of 2017 resulting in a possible cut of up to 0.5% in real wages across Northern Ireland.
- Upward pressure on wages and increased input costs more generally will eventually erode Northern Ireland's current advantage in cross border trade and exports more generally.
- Whilst leaving the Single Market does pose significant difficulties for the Northern Ireland economy, it would not benefit Northern Ireland to remain in the Single market if the rest of the UK decided to leave.
- If the UK seeks access to the Single Market through Equivalence arrangements the Northern Ireland Executive should seek additional powers in product and market regulation to maintain optimal arrangements for both EU and GB trade.

- A Hard BREXIT will in all likelihood also involve the UK leaving the Customs Union and this represents a more immediate and direct threat to trade for Northern Ireland. Rules of Origin procedures will lead to increased bureaucracy for firms in Northern Ireland and will inevitably lead to the reestablishment of customs checks on the land border with the Republic of Ireland.
- An economic case can be made for Northern Ireland to remain within the Customs Union alone but this would necessitate custom checks on goods entering Northern Ireland from Great Britain.
- Outside of the Customs Union the Northern Ireland Executive should seek a regional presence for Department for International Trade in order to provide support for firms engaged in cross-border and EU trade.
- Inward migration to Northern Ireland from the European Union has had a significantly positive effect on the local labour market. Northern Ireland has historically performed badly with regard to both economic activity and skills acquisition. On both these measures people born in the EU significantly out-perform those born in Northern Ireland.
- In the event of a Hard BREXIT, the NI Executive should look for a derogation from any curbs to freedom of movement at UK level. This would both ensure an open border with the Republic of Ireland and also prevent a sudden deterioration in the Northern Ireland labour market.
- Overall a Hard BREXIT is likely to be more economically disruptive for Northern Ireland. Remaining within the Single Market and most importantly the Customs Union would be the optimal situation, but as this QEO outlines, there are policy actions that can be taken to ameliorate the economic damage if this is not the case.

# 1 Economic Trends and Outlook

## 1.1 World

The world economy has performed poorly in 2016 with relatively low levels of growth in real output, productivity and trade. Overall, global output is likely to increase by just 3% in real terms in 2016. Table 1.1 provides an overview of recent economic performance in the euro area, the UK and the US. Output and labour market performance has been weakest in the euro area partially reflecting euro area policymakers' less activist response to the post-2008. Inflation was close to zero in all three regions in 2015 principally as a result of falls in energy and commodity prices.

**Table 1.1 Dashboard of Macroeconomic Indicators, Selected Regions**

| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016* |
|---|---|---|---|---|---|---|
| **Real GDP** | | | *Percentage volume change over previous year* | | | |
| Euro area | 1.5 | -0.9 | -0.3 | 1.1 | 2.0 | 1.7 |
| United Kingdom | 1.5 | 1.3 | 1.9 | 3.1 | 2.2 | 1.8 |
| United States | 1.6 | 2.2 | 1.7 | 2.4 | 2.6 | 1.6 |
| **Unemployment**** | | | *Percentage of labour force* | | | |
| Euro area | 10.1 | 11.3 | 11.9 | 11.5 | 10.8 | 10.2 |
| United Kingdom | 8.1 | 8.0 | 7.6 | 6.2 | 5.4 | 5.1 |
| United States | 8.9 | 8.1 | 7.4 | 6.2 | 5.3 | 5.0 |
| **Inflation** | | | *Percentage annual average rate of change* | | | |
| Euro area (HICP) | 2.7 | 2.5 | 1.3 | 0.4 | 0.0 | 0.3 |
| United Kingdom (HICP) | 4.5 | 2.8 | 2.6 | 1.5 | 0.1 | 0.7 |
| United States (CPI) | 3.1 | 2.1 | 1.5 | 1.6 | 0.1 | 1.2 |
| **Compensation per Employee** | | | *Percentage change from previous period* | | | |
| Euro area | 1.8 | 1.1 | 1.4 | 1.3 | 1.4 | 1.7 |
| United Kingdom | 1.1 | 1.7 | 1.5 | 0.3 | 1.8 | 2.0 |
| United States | 2.6 | 2.4 | 1.1 | 2.6 | 2.2 | 2.9 |
| **Current Account Balance** | | | *Percentage of Gross Domestic Product* | | | |
| Euro area | 0.4 | 1.3 | 2.2 | 2.5 | 3.2 | 3.4 |
| United Kingdom | -1.8 | -3.7 | -4.4 | -4.7 | -5.4 | -5.9 |
| United States | -3.0 | -2.8 | -2.2 | -2.3 | -2.6 | -2.5 |
| **Fiscal Balance** | | | *Percentage of Gross Domestic Product* | | | |
| Euro area | -4.2 | -3.7 | -3.0 | -2.6 | -2.1 | -2.0 |
| United Kingdom | -7.6 | -7.7 | -5.7 | -5.6 | -4.2 | -3.3 |
| United States | -9.6 | -7.9 | -4.4 | -4.2 | -3.5 | -4.1 |

**Notes:** *2016 figures for *GDP*, *Inflation*, *Current Account* and *Fiscal Balance* are latest IMF projections while 2016 *Unemployment Rate* and *Compensation per Employee* are latest OECD projections.
**National definitions.

**Sources:** IMF *World Economic Outlook*, OECD *Economic Outlook*

Brexit and the problems and uncertainties associated with what is likely to be a complicated, fraught and drawn out Brexit process are likely to weigh on growth in a number of European economies over the next two to three years. The size of the economic impact is difficult to forecast but a significant medium-term hit to the UK's income and output levels appears to be almost inevitable.

A Medium-term slowdown in the Chinese economy remains a concern for the wider Asian economy although China's recently implemented fiscal measures are stimulating domestic production in the short-term. On a more positive note the outlook for commodity exporters is gradually improving while the US president-elect's fiscal expansion should boost demand in the United States. Overall, the major institutional forecasters such as the IMF and the OECD are projecting that global growth will improve to between 3% and 3.5% in 2017.

The euro area's recovery remains weak despite very supportive monetary policy and financing conditions. Annual inflation was 0.5% in October while real GDP was up 1.6% in the third quarter compared with the same quarter of 2015. The low growth and inflation environment is weighing on bank profitability with potentially negative downstream implications for credit growth to firms and households. The European Central Bank is very likely to continue with its highly supportive monetary policy stance over the short-term. However, this stance is not sustainable over the long-term.

In addition, the euro area's unemployment rate was still in double digits in September (10%), albeit declining, and the general lack of wage growth and investment growth remain concerns. The ongoing political uncertainty may increase downward pressure on the euro as multiple European countries go to the polls during the next 12 months. The European Commission's recent call for a more expansionary approach to fiscal policy based on increased investment is a welcome and long overdue policy shift.

The US Federal Reserve will probably tighten monetary policy gradually over the next 12 months while the president-elect has signalled his intent to cut business and corporate taxes, increase spending on infrastructure and cut regulations. On balance this combination could increase the value of the US dollar and depending on the scale of the fiscal adjustment could also boost domestic demand and inflation. However, the plans to curb immigration and trade are likely to reduce the US economy's medium-and-long-term potential growth rates.

## 1.2 Republic of Ireland

***Trends***

The headline national accounts, including GDP, GNP and the Current Account Balance, were heavily distorted in 2015 by multinational activity. This distortion has increased the difficulty in interpreting the Republic's economic performance. Even so, there is evidence that the real economy grew strongly in 2015 and is continuing to grow strongly in 2016. GDP increased in real terms by 4% in the first half of 2016 compared to the same period of 2015 while domestic demand grew by 5.1% in the same timeframe and personal consumption grew by 3.5%. Activity indicators such as retail sales have also been strong. The volume of retail sales grew 5.2% in the third quarter compared to last year. Table 1.2 provides an overview of the economy's recent performance.

### Table 1.2 Dashboard of Macroeconomic Indicators, Republic of Ireland

| | 2011 | 2012 | 2013 | 2014 | 2015 | Latest |
|---|---|---|---|---|---|---|
| | *Percentage volume change over previous year* | | | | | |
| Gross Domestic Product | 0.0 | -1.1 | 1.1 | 8.5 | 26.3 | 4.0 *(H1'16)* |
| Domestic Demand | 0.7 | 1.4 | -1.9 | 7.7 | 9.9 | 5.1 *(H1'16)* |
| Retail Sales | -3.0 | -1.1 | 0.7 | 6.4 | 8.2 | 5.2 *(Q3'16)* |
| Industrial Production | -0.4 | -1.5 | -2.2 | 22.9 | 34.8 | -0.9 *(Q3'16)* |
| | *Percentage annual average rate of change* | | | | | |
| Employment | -1.8 | -0.6 | 2.4 | 1.7 | 2.6 | 2.9 *(Q3'16)* |
| Average Hourly Earnings | -0.4 | 0.2 | -0.3 | -0.1 | 0.2 | 0.5 *(H1'16)* |
| Compensation per Employee | 1.2 | 0.0 | -0.7 | 1.7 | 0.8 | 0.8 (2015) |
| Inflation (HICP) | 1.2 | 1.9 | 0.5 | 0.3 | 0.0 | -0.4 *(M10'16)* |
| | *Percentage of gross domestic product* | | | | | |
| Investment | 17.2 | 19.4 | 18.2 | 20.5 | 21.1 | 22.4 *(H1'16)* |
| Current Account Balance | -1.6 | -2.6 | 2.1 | 1.7 | 10.2 | 11.0 *(H1'16)* |
| Government Balance | -12.6 | -8.0 | -5.7 | -3.7 | -1.9 | -1.0 *(H1'16)* |
| Government Gross Debt | 109.6 | 119.5 | 119.5 | 105.2 | 78.6 | 77.8 *(Q2'16)* |
| | *Percentage of labour force* | | | | | |
| Unemployment | 14.6 | 14.7 | 13.0 | 11.3 | 9.4 | 7.3 *(M11'16)* |
| Long-term Unemployment | 8.6 | 9.0 | 7.8 | 6.6 | 5.3 | 4.2 *(Q3'16)* |
| | *Percentage of households* | | | | | |
| Deprivation | 24.5 | 26.9 | 30.5 | 29.0 | n/a | 29.0 *(2014)* |
| At Risk of Poverty | 16.0 | 16.5 | 15.2 | 16.3 | n/a | 16.3 *(2014)* |
| | *Percentage* | | | | | |
| Gini Coefficient | 31.1 | 31.2 | 31.3 | 31.8 | n/a | 31.8 *(2014)* |

**Notes:** Quarterly ('Q'), half year ('H'), and monthly ('M') data is compared to the same period of the previous year. Rates of change represent the average value over the four quarters, or twelve months. *Average annual hourly earnings* compares annual hourly earnings to the previous year. *Gross Debt* is an end-year figure as a % of annualised GDP or the latest quarterly figure as % of quarterly GDP. *Unemployment* is an average for the four quarters.

**Sources:** CSO *National Income and Expenditure*, CSO *Quarterly National Accounts*, CSO *Retail Sales Index*, CSO *Industrial Production and Turnover*, CSO *Quarterly National Household Survey*, CSO *Earnings and Labour Costs Annual*, CSO *Earnings and Labour Cost Quarterly*, CSO *Consumer Price Index*, CSO *Balance of Payments*, CSO *Government Finance Statistics*, CSO *Monthly Unemployment*, CSO *Survey on Income and Living Conditions*, OECD *Economic Outlook.*

Labour market conditions continue to improve with net employment up 2.9% year-on-year in the third quarter of 2016. Total employment is now 2.04 million which is the highest recorded third quarter total since 2008. However, total employment is still 130,000 jobs below the pre-crisis peak of 2.17 million recorded in the third quarter of 2007. The unemployment and long-term unemployment rates are both on a downward trajectory with seasonally adjusted unemployment falling to 7.9% in the third quarter (7.3% in November compared to 9.1% last year) and long-term unemployment falling to 4.2%. Even so, the number of people in long-term unemployment is over 92,000 making it three times higher than it was in 2007.

Average weekly earnings grew by 1.2% in the third quarter with private sector earnings increasing 1.8%. However, average hourly earnings have yet to match the generalised improvements in the labour market and grew by just 0.2% year on year in the third quarter. An important underlying reason is the fall in hourly earnings in the public sector. Hourly earnings in the private sector increased by 0.9%. Real wages are benefiting from the general lack of inflation in the economy. Growth in the CPI (-0.3%) and HICP (-0.4%) inflation indices were negative in the year to October with '*transport*' and '*food*' causing the largest downward contributions and '*restaurants and hotels*' causing the largest upward contribution.

Residential property prices were up 7.3% in the year to September with prices outside of Dublin increasing 11% in the same period. The recent Central Bank announcements on mortgage lending may offer short-term relief for first-time buyers but will, in all likelihood, raise house prices and further exacerbate the accommodation crisis. Household debt now stands at €148.4 billion or 150.4% of disposable income.

Income tax receipts are 4.2% higher in year-on-year terms to end-October, while VAT receipts are up 4.7% and Excise duties are up 15.2%. Corporate tax receipts are up just 0.6% year-on-year. However, this performance is 40.1% above profile reflecting a continuation of the unexpectedly high level of corporate tax receipts in 2015. Tax receipts are up 4.7% year-on-year while government revenue is up just 2.2%. The difference reflects a decline in non-tax revenues (mainly dividends and Central Bank surplus income). Public spending has increased by 0.9% on a year-on-year basis with a 4.3% increase in health spending absorbing 95% of the net increase. Overall, the general government balance has improved by €531m compared to end-October 2015 and the public finances are now on target for a deficit of close to 0.9% of GDP.

**Box 1.1 Fiscal Policy in the Republic of Ireland: Budget 2017**

Budget 2017 utilised approximately €1.2 billion of fiscal space upon an expenditure and taxation package (the nominal package was €1.3 billion). The net taxation package cost €295 million while there was an €805 million current spending package and a €200 million capital spending package. The general government deficit is now expected to improve to 0.4% of GDP in 2017. The ESRI found that the impact of Budget 2017 on household incomes was rather small with only the lowest income quintile gaining by more than 0.5% in income terms. It is estimated there is €1.2 billion of unused net fiscal space available for Budget 2018 and a further €2.7 billion for each of the three subsequent years. Contained within these numbers will be the cost of new public sector pay arrangements

The Department of Finance estimate that the structural deficit will fall to 1.1% of potential GDP in 2017 The euro area as a whole is forecast by the European Commission to have a structural deficit of 1.4% of potential GDP ranging from a deficit of 3.2% in Spain to a surplus of 0.5% in Germany. The Republic's fiscal position therefore appears reasonably healthy compared to the euro area as a whole. The Department also estimate that the Republic's debt to GDP ratio will fall to 74.3% of GDP in 2017. However, the Republic's debt-to-government revenue ratio is at the higher end of euro area countries, the Republic is the euro area country most exposed to a Brexit related shock, and there is at least a possibility that the Republic is temporarily benefiting from an unsustainable corporate tax bubble. Corporate tax has increased by 92% since 2012 and just 10 companies paid over 40% of all corporate tax revenue in 2015. The EU's new emphasis on tackling aggressive tax avoidance (as evidenced by the Apple case) combined with increased tax competition from the UK and the US may put pressure on future corporation tax receipts.

In this environment of fragile debt sustainability, the Republic is faced with growing spending pressures from a larger and ageing population. In addition, the ongoing housing crisis will require significant annual fiscal commitments to resolve and there is an urgent need for higher levels of public spending on productivity enhancing areas such as infrastructure and education.

In this context, the erosion of the tax base can generously be described as unwise. The cut in Capital Acquisition Tax was particularly unwelcome as it is a notably growth friendly form of taxation and its erosion will deepen intergenerational wealth inequality. The cut in the Universal Social Charge was also unwelcome as it is a progressive and broad based tax. The average headline tax rate for the average income earner was already the second lowest in the EU. The introduction of a €50 million *'help to buy'* income tax rebate as a demand-side housing measure will do very little to ease the ongoing housing supply problem, will increase house prices, and represents an inefficient and regressive use of limited resources. The postponement of the property re-valuation to 2019 is unwelcome as the property tax is an extremely growth friendly tax. The delay is a gain to property owners at the expense of the rest of society.

More positively, the *'comprehensive programme of targeted compliance interventions'* introduced to help tackle offshore tax evasion and the '*increased resources to confront non-compliance'* are welcome policy developments although the potential yield from these measures is highly uncertain apriori. The increased funding for childcare was welcome and a good first step. The childcare package should help increase labour force participation rates amongst second earners and lone parents and this will boost the economy's productive capacity.

***Outlook***

The National Accounts have become increasingly difficult to interpret while GDP and GNP are becoming less useful as gauges of economic performance within the Republic of Ireland. On balance our view is that the outlook for the Republic's economy remains broadly favourable but that risks to output growth and employment growth are intensifying (see Box 1.2) while signs of a marginal slowdown in growth may be starting to emerge.

Our baseline assumption is that the economy is not yet overheating and that there remains scope for above trend growth in the economy. Even so, the outlook for growth is not as favourable to growth as it was in 2015 and early 2016. We expect the economy to grow by over 4% in real GDP terms in 2016 before slowing to around 3.5% growth next year. This assumes Brexit exerts a negative effect on the economy but also that monetary policy remains extremely supportive. We anticipate falling unemployment, increasing underlying investment and increasing wage and price inflation as the output gap closes overthe near-term.

Investment is expected to make the largest contribution to real economic growth over our forecast horizon with significant scope for above-trend catch-up growth given the persistently low underlying investment ratio in recent years and the expected increase in housing output. Personal consumption should continue to grow reasonably strongly on the back of rising employment and wage levels, improving household wealth and debt dynamics, and more supportive fiscal policy. Even so, we forecast that the growth momentum in personal consumption will start to decline over the forecast period and there is emerging evidence that consumer confidence is deteriorating.

Economic growth has been very much domestic demand driven in 2016 with the contribution of net exports close to zero. There is a very high level of uncertainty surrounding the trade forecasts as the activities of a small number of multinationals are exerting a very strong effect on both exports and imports. The future direction of these activities and the potential for future level shifts in contract manufacturing is inherently difficult to forecast. Even so, we anticipate that net exports will make a small positive contribution to growth in 2017, albeit with imports growing at a faster rate than exports. The higher rate of import growth will partially be driven by the anticipated growth in real disposable income, personal consumption and investment.

Net employment should increase by around 70,000 jobs over the next two years with the average unemployment rate falling to 7.5% in 2017 as cyclical unemployment declines and then falling again to around 7.0% in 2018. Diminishing labour market slack will translate into higher average hourly earnings, albeit with significant sectoral differences. We expect that average hourly earnings will grow by around 2.3% in 2017 though this forecast may be overly cautious as there is now a high degree of pent up pressure for wage increases. The extremely low price inflation that has prevailed in most developed economies should gradually cease to be a feature as 2017 progresses. We expect that the recovery in the labour market combined with increased domestic demand and diminishing drag from oil prices will cause HICP inflation in the Republic to steadily converge towards the 2% target over the next 18-24 months.

The general government deficit is on course to improve to 0.9% of GDP in 2016. Based on our projections for output and the labour market the deficit should improve to 0.5% of GDP in 2017 following the €1.3 billion expansion announced in Budget 2017.

## Table 1.3 Macroeconomic Projections, Republic of Ireland*

| | 2015 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| **Real Output** | | *Percentage real change over previous year* | | | |
| Gross Domestic Product | €255.8bn | 26.3 | 4.1 | 3.7 | 3.6 |
| Personal Consumption | €92.4bn | 4.5 | 3.7 | 2.9 | 2.5 |
| Government Consumption | €27.0bn | 1.2 | 3.4 | 1.7 | 1.5 |
| Investment | €54.1bn* | 32.7 | 11.6 | 9.6 | 7.0 |
| Exports | €317.2bn | 34.4 | 5.3 | 5.0 | 4.5 |
| Imports | €236.0bn | 21.7 | 7.2 | 6.3 | 5.0 |
| **Earnings** | | *Percentage nominal change over previous year* | | | |
| Average Hourly Earnings | €21.91 | 0.2 | 1.3 | 2.3 | 2.4 |
| **Government Finances** | | *Percentage of GDP* | | | |
| General Government Balance | -€4.6bn | -1.8 | -0.9 | -0.5 | 0.1 |
| Gross Debt | €201.3bn | 78.7 | 75.3 | 72.8 | 69.5 |
| **Labour Force** | | *Percentage change over previous year* | | | |
| Employment | 1,963,550 | 2.6 | 2.6 | 1.8 | 1.6 |
| | | *Percentage of labour force* | | | |
| Unemployment | 203,625 | 9.4 | 8.2 | 7.5 | 7.0 |

**Notes:** *Macroeconomic projections for the Republic of Ireland economy are from the NERI's Autumn 2016 Quarterly Economic Observer (QEO) and are reprinted here for convenience. The next set of projections will be published in the Spring 2017 edition of the NERI's QEO.
Projections for *Gross Domestic Product* and components refer to real economic activity; *Investment* refers to Gross Fixed Capital Formation; *Employment*, *Unemployment* and *Earnings* all represent the average value over the four quarters.
*Gross Fixed Capital Formation excluding intangibles was €30.6 billion in 2015.

**Sources:** NERI estimates for 2016-2018; 2015 data is from CSO *National Income and Expenditure*, CSO *Earnings and Labour Costs Survey*, CSO *Government Finance Statistics* and CSO *Quarterly National Household Survey*.

**Box 1.2 Macroeconomic Risks and Uncertainties**

The macroeconomic outlook is clouded with uncertainty. One of the most important of these uncertainties is the impact of **Brexit** and while our baseline expectation is that Brexit will have a negative impact on the Republic's economy, it is difficult to quantify the size of this effect. Ultimately the size of the impact will depend on the nature of the final agreement negotiated between the European Union (EU) and the United Kingdom (UK) particularly in relation to trade. Broadly speaking the harder the Brexit the more damaging the impact for the Republic's economy. There will be exchange rate movements against Sterling if the probability of a hard Brexit is perceived to increase. This would have a damaging impact on exports with the Border counties and indigenous exporters most affected. In the medium term, a 'hard' WTO type outcome would have a significant negative impact on UK trade and investment and a deleterious impact on trade with the UK. Trade barriers would also reduce economy-wide efficiency over time thereby damaging productivity growth.

As a small open economy the Republic's growth prospects are linked to growth in its trading partners. Recent political developments in the United States and the UK have added to the **uncertainty surrounding economic policy and economic prospects** in these countries. Upcoming elections in Italy, France, Germany and other countries have the potential to produce similar shocks. The impact of a **Trump presidency** on the Republic's economy is difficult to assess as it is unclear which if any of the president-elect's pre-election promises will become post-election policies. A move towards protectionism and/or a significant change in corporation tax policy are both downside risks to the Republic's economy. The Republic's tax and regulatory advantages in securing foreign direct investment may also come under pressure from **corporate tax reduction in the UK**, from a greater willingness of the European Union to punish aggressive tax avoidance, and from increased **momentum to establish a Common Consolidated Corporate Tax Base** in the EU. The Republic could however benefit from displaced FDI displaced from the UK post-BREXIT.

A **tightening of euro area monetary policy** would have a damaging impact on the economy. Higher interest rates would reduce demand and be particularly damaging to the Republic's economy with its high private and public debt overhangs. Monetary tightening is very unlikely in the short-term. On the other hand, sharp swings in currency movements are highly likely in the next two years given the uncertain and shifting evolution of Brexit. A sustained **appreciation in the euro** would have adverse implications for exporters. The Republic is an energy importer and is therefore gaining from the current low cost of energy. A faster than expected **rebound in energy prices** would negatively impact on corporate balance sheets and investment as well as on real household disposable incomes and personal consumption.

There are always major uncertainties inherent to our forecast. For example, **labour productivity** is notoriously volatile and it is difficult to forecast given that it is dependent on hard to track processes such as the generation and diffusion of innovation as well as changes in the composition of inter and intra sector employment. Our projections assume the recent dip in productivity growth in the developed economies is a transitory phenomenon. A further uncertainty relates to the amount of damage done to **the quality of labour supply** as a consequence of the prolonged economic crisis and stagnation. This is difficult to measure but if the damage done is greater than assumed the potential for above trend growth over our forecast horizon and our assumption of a negative output gap may well be overstated.

## 1.3 Northern Ireland

Despite the perception of uncertainty and volatility surrounding BREXIT, statistics for the Northern Ireland (NI) economy published since the referendum do not indicate any significant deterioration. No official estimates of output for NI cover the period since June but unofficial estimates from the Purchasing Manager's Index show that business activity remains stable. Estimates of UK GDP in the third quarter of 2016 would also seem to indicate that the pace of recovery has not been interrupted by the referendum result. The labour market has strengthened over the summer months, and much of this may be attributable to a short-term boost from a weaker currency.

### Table 1.4 Dashboard of Macroeconomic Indicators (Northern Ireland)

| | 2011 | 2012 | 2013 | 2014 | 2015 | Latest |
|---|---|---|---|---|---|---|
| | | | *Percentage volume change over previous year* | | | |
| Gross Value Added | -0.2 | 1.1 | 0.6 | 0.7 | - | 0.7 *(2014)* |
| NICEI | -1.7 | -1.3 | 0.1 | 0.7 | 1.4 | 1.0 *(Q2 2016)* |
| Index of Services | -2.7 | -1.2 | 0.7 | 1.4 | 1.4 | 1.7 *(Q2 2016)* |
| Index of Production | 7 | -1.4 | 1 | 2.2 | 1.9 | 0.6 *(Q2 2016)* |
| | | | *Percentage annual average rate of change* | | | |
| Employment Rate | 2 | -0.3 | -0.6 | 1.8 | 0.3 | 2.1 *(M7-M9 '16)* |
| Average Hourly Earnings | 1.7 | 1.5 | 2.5 | -1.3 | 4.2 | 4.2 *(2016)* |
| Price Inflation (UK) | 4.5 | 2.8 | 2.6 | 1.5 | 0 | 0.9 *(M10 '16)* |
| | | | | *Percentage of GVA* | | |
| Exports | 28.7 | 28.4 | 29.7 | 28.4 | - | 28.4 *(2014)* |
| Government Spending | 59.4 | 58.5 | 57.7 | 57.6 | - | 57.6 *(2014)* |
| | | | | *Percentage of labour force* | | |
| Unemployment | 7.2 | 7.5 | 7.5 | 6.4 | 6.1 | 5.6 *(M7-M9 '16)* |
| Youth Unemployment | 18.2 | 20.1 | 22.5 | 19 | 19.3 | 15.0 *(M7-M9 '16)* |
| Long-term Unemployment | 3.2 | 3.8 | 4 | 3.4 | 3.6 | 2.4*(M7-M9 '16)* |
| | | | | *Percentage of households* | | |
| Relative Poverty | 20 | 22 | 19 | 21 | - | 21 *(2014)* |

**Notes:** Employment Rate refers to all persons in employment (ILO definition) aged 16-64 as proportion of all persons 16-64. GVA is deflated using UK GDP deflator. NI Exports refer to sales outside the UK.

**Sources:** ONS *Regional Gross Value Added (Income Approach)*; HMT *GDP Deflators*; NISRA *Northern Ireland Composite Economic Index*; NISRA *Index of Production*; NISRA *Index of Services;* NISRA *Labour Force Survey*; NISRA *Annual Survey of Hours and Earning*; ONS *Consumer Price Inflation*; HMT *Public Expenditure Statistical Analyses*; NISRA *Households Below Average Income*

The Northern Ireland Composite Economic Index indicates that output growth continued in the second quarter of the year, increasing by 1% in real terms. There was a significant upturn in construction sector output which had contracted sharply at this time last year. Statistics suggest that much of the increase in construction sector activity was in private housing, commercial new build and infrastructure while public housing remained stagnant. The boost in construction output is somewhat at odds with jobs statistics for the sector which indicate that there are 5,000 fewer construction sector jobs since the beginning of 2016. Once again, the output figures may be capturing work carried out by NI firms in the Republic of Ireland (ROI) and Great Britain (GB). This should be reflected in output statistics for the construction sector in the future in order to avoid any distortionary impacts.

There was a small increase in output for the production sector but this masks some worrying trends for particular industries. Food, Beverages and Tabaco manufacturing saw a quarterly decrease but the sector has been in continual decline since the middle of 2013. This is worrying because food manufacturing has been identified as one of the sectors most vulnerable to trade disruption from BREXIT. Engineering and allied industries also saw a significant contraction and this is concerning in the context of the recently announced redundancies for this sector particularly aerospace engineering. The pharmaceutical sector had seen a significant upturn in output last year increasing by 17% in the 12 months up to the first quarter of 2016. However, this looks to have been a short-lived boost as output decreased by almost 6% in the second quarter of 2016.

In the labour market, the seasonally adjusted unemployment rate for NI decreased to 5.6% in the three months to September, a decrease of 0.4 percentage points. This continues a positive trend since the beginning of the year but it is worth noting that when unemployment began falling in early 2013 both the UK and NI rate were at similar levels and fell at a similar rate. This trend stopped in mid-2014 when unemployment increased in NI, and since then there has been a persistent gap of almost 1 percentage point. However, economic activity is now at its highest rate since quarterly Labour Force Survey records began and this may explain why unemployment levels in NI have struggled to match the performance of the UK as a whole. People moving out of economic inactivity are moving into employment but many are also moving into unemployment.

There has also been a divergence in the unemployment rate based on gender. Whilst there was a decrease in the overall rate, much of this has been driven by the female unemployment rate which fell from 4.7% to 3.7% in the third quarter of this year. The male rate of unemployment by contrast actually increased from 7.2% to 7.3% whilst Oftentimes these quarterly changes can be attributed to sampling error in the LFS but the scale of these movements and their persistence over the last 12 months does indicate the emergence of a trend worthy of investigation. The latest redundancy figures show that over half of the confirmed redundancies in 2016 have come from the manufacturing sector. As the manufacturing sector has almost 80% male employment, this may be what is being picked up in the LFS figures. There has also been a marked increase in youth unemployment which had fallen steeply in recent months. Youth unemployment levels have fallen from a worrying high of 25% in 2013 to 14% earlier this year. The costliest consequences of elevated levels of youth unemployment will be felt in the long term in the form of reduced productive capacity, so there is no room for complacency on this issue.

There were positive trends for wages in NI in 2016 with the median full-time weekly wage increasing by 2.2%. This is down on the 5.4% growth recorded in 2015, but it should still result in a real terms increase for 2016. The introduction of the National Living Wage can be seen in the 10% increase in the hourly wage for the bottom 10% of income earners. Reflecting the gender divide in employment prospects, median female wages increased by 4% compared to 1.5% for male employees.

The fall in the value of Sterling will have had a significant impact on the NI economy over the last three months through increased cross-border spending particularly in border counties. The future prospects for this are discussed in greater detail in Section 2, but it is likely that some of this activity has been captured in labour market statistics over the period. There is no sectoral breakdown of employment in the LFS figures but we would expect sectors such as retail and hospitality to benefit most from the weakened currency. There are no official statistics for retail sales in NI, but UK figures indicate strong performance overall since June. Indicators from the tourism sector in NI also point to a significant improvement. Hotel room sales in NI in September were up 13% on the same period last year. This increase in activity is likely to have boosted employment in recent months and but the possible longer-term effects of BREXIT on the labour market will not become clear until the impacts on investment, trade and output have materialised.

Property prices were a key concern in the run up to the BREXIT referendum with a HM Treasury forecast that the value of properties in NI would drop by an average of £18,000 two years after BREXIT. Whilst the UK has not left the EU as of yet, the average house price in NI has remained static as £124,000 in the three months since the EU referendum. Whilst there has been no fall-off in values, it is clear that the referendum result has paused whatever small recovery that may have been taking hold in the market.

**Box 1.3 The Autumn Statement 2016**

The Autumn Statement delivered on the 23 of November was the first substantial financial statement made by the government since the BREXIT referendum result in June. Naturally the referendum and its consequences featured heavily in the announcements. The UK economy has sustained growth in the months following the referendum but it is still clearly too early to make any definitive forecasts for the longer term.

The Office for Budget Responsibility predicted that UK growth would be 2.1% in 2016 and 1.4% in 2017. This weaker growth is attributed to lower investment impacted by uncertainty and reduced consumer spending due to higher inflation. While these figures represent a deterioration, the outlook is not as severe as projected before the referendum. BREXIT has also impacted on forecast for the public finances adding to both debt and deficits in the short term. The Government has therefore abandoned its target of reaching a budget surplus in 2019/20. The OBR calculated that of the **£122bn extra borrowing** that will be required over the next 5 years, £58.7 or just under half of that extra money can be attributed to BREXIT.

The **forecasts for earnings were also downgraded** to the extent that real average weekly pay will not now reach its pre-crisis peak in 2020, as forecast in March. The deterioration is split between higher inflation and lower nominal pay with each accounting for half the overall decrease. Earnings will now be below their 2007 peak beyond the forecast period to 2021. Section 2 of this publication outlines how Sterling's post BREXIT depreciation will affect inflation and wages in NI. An increase of 30p in the National Living Wage will give a boost to many low-paid workers, but this will not make up for the shortfall many working families will face arising from changes to tax credits when Universal Credit is rolled out across the country.

The focus on productivity was a welcome feature of this year's Autumn Statement. This has been a perennial and persistent weakness of both the UK and NI economies. A commitment to increased Research and Development spending along with the creation of a £23bn productivity fund were bolstered by an increase in public investment which should see NI benefit with **an additional £250m** of Barnett consequentials over the next five years. While these actions are welcome they are underwhelming given the scale of the problem that the UK economy faces in this regard. The reduction in public investment in the early years of the previous government did much to reduce the economy's productive capacity and it seems that the current government have come around to the logic of borrowing for investment a little late in the day.

The government also set out its intention to continue with a planned reduction in corporation tax to 17%, having earlier floated the idea of further reductions to 15%. However, taken together with the corporation tax implications of a Trump presidency outlined in Box 1.2, the Northern Ireland Executive needs to give serious consideration to **abandoning its plans to introduce a separate 12.5% rate in NI**. This should be done not only out of consideration for the costs involved, which have always been a concern, but also because the effectiveness of this policy must now be seriously in doubt.

# 2 The Implications of a 'Hard BREXIT' for the Northern Ireland Economy

## 2.1 Introduction

The result of the BREXIT referendum on the 23rd of June gave popular assent to the United Kingdom (UK) government to remove the UK from the European Union (EU). However, it gave no further guidance on what, if any, relationship would remain between the two. There are several options before the UK government. However, in recent months a political momentum has built up behind the proposal for a 'hard' BREXIT. Whilst some consider the term to be pejorative, it is broadly understood to describe a situation where the United Kingdom leaves the EU and does not apply for external membership of any EU orientated economic or social structures.

A previously published NERI working paper explored the sectors of the economy in Northern Ireland (NI) that would be vulnerable to BREXIT. This analysis seeks to build on that work by outlining how the prospect of a hard BREXIT has already influenced the economic climate and how hard BREXIT decisions on trade and migration will ultimately impact the NI economy. To the extent that it is possible to be prescriptive at this stage, there are policy proposals designed to minimise the disruption to trade, employment and wages outlined in this section. Finally, the narrow focus in this section on a hard BREXIT does not rule out the possibility of other outcomes, it is simply scoping the impacts of one particular scenario.

## 2.2 Immediate Impacts

In the run-up to the EU referendum there were numerous forecasts and projections that attempted to quantify the economic impact of BREXIT on the UK economy. However, most of these analyses relied on a range of assumptions about the BREXIT process itself post-referendum. In reality the political intricacies involved in the UK's exit from the EU are highly unpredictable and complex. This means that the only discernible short term impact that the BREXIT decision is likely to have is uncertainty and volatility. Official and unofficial statistics have indicated that both consumer and business confidence have remained fairly stable since the referendum result. However, the significant decrease in the value of Sterling indicates that uncertainty and doubts about the future path of the UK economy have been growing at home and amongst the UK's trading partners.

## Chart 2.1 Sterling Effective Exchange Rate June – November 2016


**Sources:** Bank of England (2016) Effective Exchange Rates
**Notes:** The Effective Exchange Rate Index is a measure of the overall change in the trade-weighted exchange value of sterling.

As Chart 2.1 shows Sterling had lost 16% of its value by early October and has since stabilised to12% below where it was immediately before the referendum result. There are mixed opinions as to whether this sudden decline will have a positive or negative impact on the UK economy. It could be argued that Sterling was over-valued before the referendum particularly because of the UK's large current account deficit. This could provide the opportunity for a natural correction that will give a boost to exporters and re-balance the economy away from areas such as finance towards manufacturing and production more widely.

There are however some problems with this proposition. Chief among these is evidence from the last significant depreciation of Sterling in 2008. From 2007 to 2010 Sterling's effective exchange rate fell by 23%, during which time there was little or no re-balancing of the economy. UK output in the manufacturing sector declined by almost 8% over the same period while goods exports increased by less than 1%. The 2007-10 depreciation did occur during the height of the financial crisis and the global economic outlook today is comparatively more benign. However, it would seem optimistic to expect a currency devaluation alone to radically alter the composition of economic activity based on past experience.

Whichever way one perceives the long-term effect of Sterling's devaluation, the immediate impacts on the domestic economy are clearer. The prospects for some exporters may be quite positive in the short run. Additionally, and almost uniquely for NI, the depreciation of Sterling is likely to give a significant boost to the domestic economy through increased consumer spending from ROI. However, both of these trends may be short-lived as import prices begin to feed through to production costs and consumer prices with potentially negative consequences for real wages.

***Consumers***

A drop in the value of Sterling will increase the price of most imports and this will feed into an increase in Consumer Price Inflation. It is not possible to definitively predict how much of Sterling's devaluation will feed through to increases in consumer prices but evidence from recent currency movements can provide some guide. Research from the Bank of England suggests that currency movements do have a substantial impact and that almost 30% of overall CPI inflation over the period 1998-2015 can be attributed to movements in the price of goods sensitive to Sterling's external value. Among the items most sensitive to Sterling were food products (potatoes in particular), non-oil fuels, books, tobacco, medical equipment and housing repairs. The most important factor in determining the overall level of feed through seems to be the nature of the depreciation itself and what causes it. An exogenous shock, such as BREXIT, is found to produce a larger and more sudden feed through.

On the basis of previous currency movements, it is possible to give some indication of how the recent depreciation may impact on inflation. Based on the import intensity of the UK economy, the Bank of England estimates that a 10% depreciation in Sterling translates into a 2.7% increase in CPI inflation over 3 years. This would imply that the UK would now see at least 3.2% increase in CPI inflation (based on a 12% depreciation), over half of which would occur in the first year.

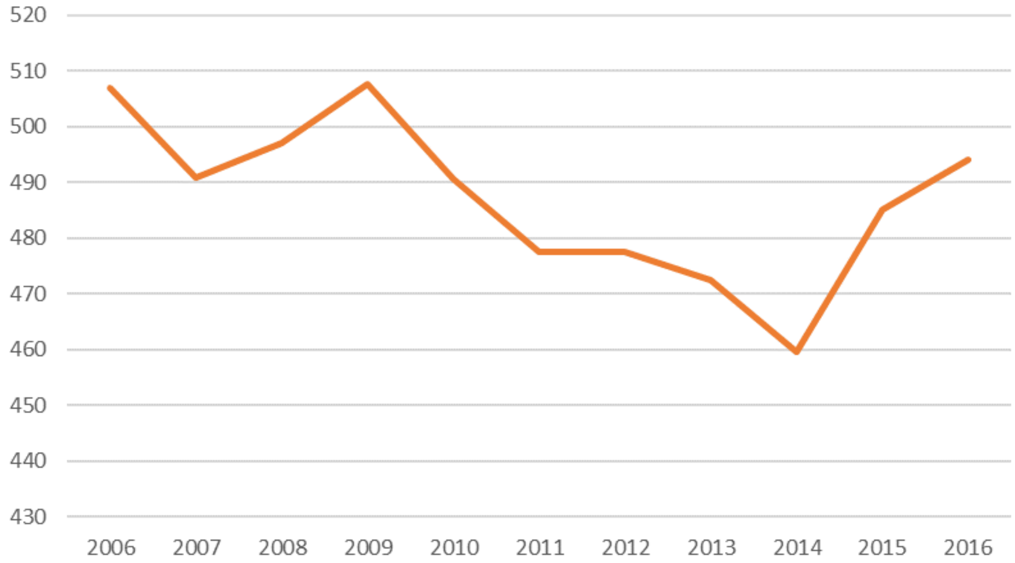
The most recent UK inflation figures indicate that inflation has already increased to an annualised rate of 1% in September and 0.9% in October, up from 0.6% recorded in July. However, it seems unlikely that any of this initial increase in inflation is due to Sterling's depreciation. Of the top 10 items in the CPI basket that are most sensitive to

Sterling's value, only two showed any increase in the September inflation figures; Products for the Repair of Dwellings, and Fuels and Lubricants. It seems quite likely then that the inflationary effects of Sterling's post-BREXIT decline are yet to be realised. If, as the Bank of England figures suggest, CPI inflation will increase by at least 3.2% over the next three years, we could expect some 1.7% of this increase in 2016/17. Adding this to the existing rate of inflation would imply an annualised rate in the region of 2.7% by the middle of next year. Whilst current price inflation data would indicate many retailers have not passed cost pressures through to consumers yet, this is probably due to a first-mover disadvantage effect. It is therefore more likely that when prices do rise it will be a domino like effect.

***Workers***

If wage increases are eclipsed by the return of high rates of inflation there will be an immediate impact on consumer spending in NI. NI saw large nominal and inflation adjusted decreases in wages over the 2009-14 crisis period. A significant upswing in nominal pay rates in the last two years coupled with low inflation has allowed workers to make up some of the ground lost over previous years. The gains in 2015 and 2016 for full time weekly wages were 5.4 and 2.2% respectively, whilst inflation was 0.1 and 0.3 over the same periods.  Chart 2.2 puts these recent increases in historical perspective. Inflation adjusted wages have seen a 7.5% cumulative increase over the past two years, following a 9.5% decrease over the previous 5 years. Wages in NI have still not recovered their pre-crisis peak and a return to elevated rates of inflation threatens to undo much of the recent progress.

### Chart 2.2 CPI Adjusted Median Weekly Wages Northern Ireland 2006-16




**Sources:** ONS (2016) ASHE & CPI

The average forecast rate of growth in wages for the UK overall, as calculated by HM Treasury, is 2.3 for 2017. In the benign scenario that 2016 wage growth in NI is sustained in 2017, real wages in NI would still fall by at least 0.5%. Whilst it may be difficult for some employers, the drop in real wages would necessitate an increase in wage settlements across the economy in order to maintain living standards. This may spread the increase in prices in the domestic economy beyond goods and services which are imported. This would begin to unwind the current, transitory competitive edge for NI in North-South trade.

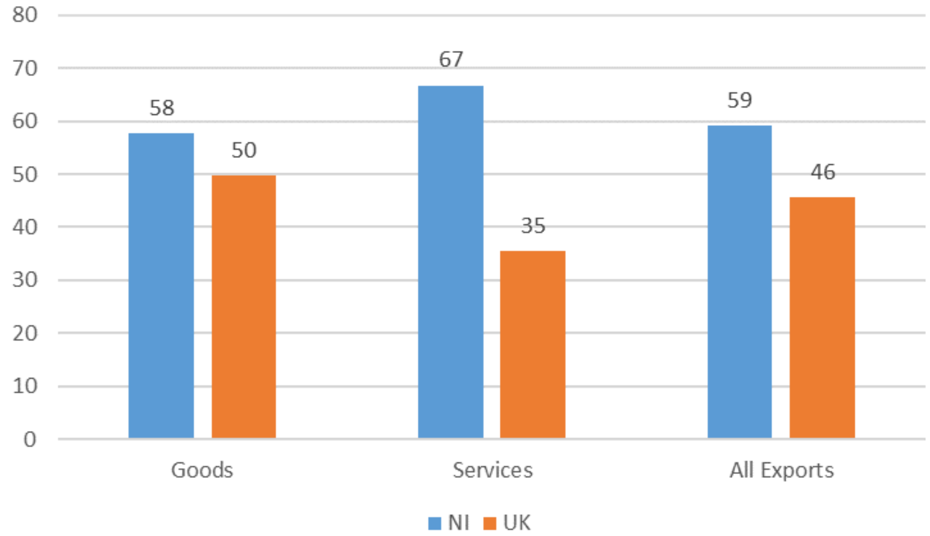
***Exporters***

Exporters should reap the benefit from a more competitive currency abroad, although this is only true up to a point. Output prices for exporters may fall, but input prices will also be subject to increases arising from exchange rate movements and subsequent domestic inflationary pressures. The UK Producer Price Index (PPI) monitors these price changes and it shows that the input price index has risen to an annualised rate of 7.2% in September up from -0.5% in June of this year and -13.4% at this time last year. Even excluding fuel and food the rate in September this year is 4.9%, up from -0.3% in June and -5.7% this time last year. There is less known about the feed through from exchange rates to producer price indices, and so consequently it is unclear how much more of an increase in the PPI is still to be expected. There is no separate PPI for NI, but there is little evidence to suggest that input price movements vary significantly from the UK and the most recent data from the Purchasing Manager's Index for NI confirm this. Whatever the gains that may be made by some exporters from a devalued Sterling in the short-term, medium term cost issues will at least partially erode these gains. Furthermore, the long-term prospects for most exporters will be determined by the shape of the post-BREXIT trading relationship between the UK, the EU and the rest of the global economy.

## 2.3 Future EU Trade links

Whilst the nature of post-BREXIT trading relationships did feature in referendum debates, the Leave side never coalesced around what any future trading arrangement with the EU would look like. As previously mentioned, the boost to exports from a weaker currency could be transitory if significant barriers to EU-UK trade are reconstructed. As chart 2.3 shows, the NI economy is more dependent on the EU as a destination for its exports than the UK as a whole. NI will be the region most impacted by disruption to EU trade, so the degree to which the UK moves toward a hard BREXIT will have significant and somewhat unique impact on the local economy.

**Chart 2.3 EU exports as a percentage of all exports NI & UK 2014**




**Sources:** ONS (2016) International Trade & NISRA (2016) Broad Economy Sales & Exports Statistics

Many have presented hard BREXIT as a choice limited to whether or not the UK retains membership of the European Single Market, but this is only one aspect of EU economic structures. A hard BREXIT will involve the UK leaving the Customs Union and this is equally important, if not more so, for the NI economy. The Single Market and the Customs Union represent the two most significant phases of European economic integration, but both can accommodate members from outside the EU. For example, it is possible to be a member of the customs union but not the Single Market (Isle of Man, Turkey, Andorra). Equally, it is possible to be a member of just the Single Market but not the customs union (Norway or Iceland).

The Customs Union was established under the Treaty of Rome in 1957 and formed the centrepiece of the new European Economic Community. Although a gradual process, it was created to eliminate customs and duties on goods traded between members and to impose a common external tariff on goods imported from outside the union. The Single Market represents an even deeper form of integration. A common market is one in which people, goods, services and capital can move freely between member countries. A Single Market has harmonised regulations for product standards, professional qualifications and other indirect barriers to trade.

***The Single Market***

The EU Single Market is, in fact, not a single market. It is a common market that is in the process of becoming a Single Market, and so it is an ambition rather than a reality. The EU institutions refer to the 'internal market' and this probably best describes the position of a common market in transition to a Single Market. Whilst internal market may be a more accurate name, the Single Market is clearly the more popular nomenclature, and so that is what will be used here.

Whilst all members of the EU are members of the Single Market, membership can also be gained by joining the European Economic Area (EEA). Norway, Iceland and Liechtenstein are non-EU members of the EEA. Membership of the EEA requires acceptance of the four freedoms of the EU (people, goods, services and capital) and also requires contributions to the EU budget. Acceptance of the free movement of people under the EEA is one of the most significant issues motivating a hard BREXIT.

It should be noted however that the EEA does not grant membership of the Single Market on the same basis as the EU. EEA membership permits participation in the Single Market but the regulation of that Single Market remains largely the purview of the EU. Norway, for instance must accept regulations and laws set by Brussels on issues of the Single Market without any substantial input. The future regulatory and trading environment within the Single Market will quite naturally reflect the strengths and weaknesses of those countries who remain members of the EU.

It could be argued then that a hard BREXIT gives the UK the flexibility to choose between adopting EU mandated regulations or creating a set of its own. A substantial amount of the trade liberalization that has already taken place between the UK and the EU could be preserved by the UK government. Indeed, it has been argued that the UK could maintain access to the Single Market by copying new EU regulations and standards under arrangements referred to as 'Equivalence'. By mimicking regulations in certain sectors such as financial services, the UK could, subject to EI agreement, maintain 'access' to the Single Market for these sectors without needing to sign up to full membership of the single market. However, there is quite a distinction between 'access to' and 'membership of' the Single Market.

As a member of the Single Market, Norway has the right to appeal laws and regulations passed by other members of the EEA which it believes are distortionary to the Single Market through the EFTA court system. In a hard BREXIT scenario, where the UK has only access to the Single Market through equivalence arrangements, the UK would be powerless to stop such behaviour unless it adversely impacted another EEA member, and they sought to appeal it.

For NI, proximity and a close trading relationship with ROI amplifies the concerns outlined above. If the UK regulatory environment diverges significantly from that of the Single Market into the future, cross-border trade and the all-island economy could be significantly impacted. Clearly, the optimal situation would be for NI and the UK as a whole to remain in the Single Market. However, given the volume of trade between NI and Great Britain (GB), it would not be optimal for NI to remain within the Single Market if GB were to leave. While NI has sales of £3.5bn annually to ROI, it has sales to GB amount that amount to over £12.5bn. This is the conundrum that NI faces in a hard BREXIT scenario; it will lose cross-border trade to ROI outside the Single market, but not enough to warrant NI diverging from the UK.

However, outside of the Single Market, responsibility for policy in many areas of market regulation will return from the EU authorities to the UK government. The process need not stop there, because the NI Executive also has competency in many of these areas. The Executive could use its powers in areas such as employment law, energy regulation and consumer affairs to maintain optimal arrangements for both EU and GB trade. Furthermore, the Executive could seek new powers in areas like consumer goods safety and regulation, which are currently reserved to Westminster but which were recently transferred to the Scottish government. If the UK will look to trade with the Single Market through equivalence arrangements, it would only be prudent for devolved administrations to seek additional powers in order to shape domestic markets to suit existing trade flows.

***The Customs Union***

Whilst common markets are not that prevalent in multi-lateral trade agreements, customs unions are more widespread. However, the Customs Union has received far less attention than the Single Market in post-BREXIT analysis. This is because most people seem confident that the EU and the UK can quite reasonably retain tariff free trade in a new free trade agreement because it would be mutually beneficial. This could be done under the existing European Free Trade Association, of which the UK was a member prior to joining the EEC 1973. Free, or custom and duty free, trade between the UK and the EU should not pose too much of a problem, the problem arises when goods from beyond the UK and the EU are involved.

As outlined earlier a customs union seeks to impose a common external tariff so that goods originating from outside the union can be freely traded amongst member countries. Without the common external tariff, countries would have incentives toward competitive tariff rates and the system would break down. Some might argue that the customs union is not that important if, in reality, it will only affect trade in goods from outside the EU. There are two central problems with this proposition.

In the first instance, many people underestimate the importance of non-EU imports in UK-EU trade. The problem is not the imposition of tariffs on UK firms exporting non-EU products into the EU, there is no welfare loss to the UK in that scenario. However, a problem arises when non-finished goods or inputs are considered. The modern, globalised manufacturing process has led firms to adopt diverse and varied supply chains. In the UK, much of non-agricultural manufacturing is about value-added rather than primary production. This means something that we might consider to be a NI product is in fact made up of varied and in many cases, non-EU parts. Exporting such a product into the EU customs union is complex and is subject to 'Rules of Origin' regulations.

Rules of Origin dictate that for a good to be considered a domestic product of a country it must be wholly or substantially produced in that country. If a product does not meet that definition, it is subject to EU tariffs upon arriving in the customs union. Where this presents a real difficulty is the definition of "substantially produced". The EU regulation specifies that:

*"Goods whose production involved more than one country shall be deemed to originate in the country where they underwent their last, substantial, economically justified processing or working in an undertaking equipped for that purpose and resulting in the manufacture of a new product or representing an important stage of manufacture". (Article 24 of Council Regulation No 2913/92)*

The tariffs that are levied may only apply to a few firms in the end, but it is the bureaucracy involved in deciding whether a product qualifies for a tariff or not that presents the real barrier to trade. This poses a particular difficulty for NI and cross border trade. Irrespective of any agreements on freedom of movement of persons, it is difficult to envisage a situation where there will not be some sort of customs border on the island of Ireland enforcing rules of origin regulations if the UK leaves the EU customs union.

Secondly, the Customs Union does impose significant tariffs on imported goods, and large ones for certain sectors. This most prominent of these is the set of tariffs imposed by the EU on imported food and agri-food products. The trade-weighted average tariff imposed on agricultural imports into the EU was 22.3% in 2013 according to the World Trade Organisation. Obviously, this scale of tariffs would present an almost insurmountable challenge to the NI agriculture and food manufacturing sector. Whilst countries such as New Zealand do sell agricultural products into the EU, those exports account for 2.8% of GDP in NZ, compared to almost 11% in NI. In a hard BREXIT scenario, WTO level tariffs could be mitigated in any EU-UK free trade agreement, although it should be noted that certain agricultural products were excluded from the recent free trade agreement between the EU and Canada. However, serious threats remain even in the more benign scenario of zero tariffs in a EU-UK FTA.

Outside of the customs union, the UK would naturally seek to broker new trade deals around the world. The EU, as an economic block with nearly half a billion consumers, carries significant clout in trade negotiations and this is one of the reasons that it has been able to make trade deals whilst retaining such large import tariffs on agricultural goods. That the UK could retain these tariffs in future negotiations is questionable and whether the UK would even fight to keep them is also debateable. There has been a long history of opposition within the UK to the Common Agricultural Policy and the system of tariffs that support it. One of the most prominent arguments against the UK joining the EEC in 1973 was the effect it would have on food prices and many now see BREXIT as an opportunity to drop tariffs on all agricultural imports. Whilst this would give a windfall gain for consumers, the speed of any such adjustment has the potential overwhelm the agricultural industry in NI and significantly impact the agricultural export market in ROI too.

The Customs Union is possibly more important for NI as it will become a more immediate and visible barrier to trade on the island of Ireland in the event of a hard BREXIT. There have been varied discussions about a digital customs frontier but these seem somewhat detached from reality. While Norway is in the Single Market, it is not in the customs union and therefore the border between Norway and Sweden requires customs posts. If Norway and Sweden, both members of the Single Market, could not find a borderless solution, why would it suddenly be possible for the island of Ireland?

While the economic case for NI remaining in the Single Market without the rest of the UK is not particularly strong, there is a stronger case for NI to remain within the Customs Union even without Great Britain. In this scenario, the part of the UK that leaves the Customs Union (presumably GB) would have to agree a free trade deal with the EU to enable tariff free trade between the GB and NI. The only catch would be that NI would have to impose rules of origin on goods imported from GB and vice versa. The benefit though is that customs checks at sea or air ports are less cumbersome or trade inhibiting than those on land borders. While it is theoretically possible, there are significant political problems with this option. Many politicians in NI may take issue with a deal that erects a small barrier to trade with GB to ensure the absence of one with ROI.

The NI executive should focus on providing support to NI firms especially SMEs in dealing with rules of origin and other obstacles to trade with ROI and the rest of the

EU. The creation of the new Department for International Trade recognised the need for enhanced capacity within the UK government and a proportional effort will need to be made with all the devolved administrations too. An enhanced role for the NI Executive in trade policy or a significant commitment of resources by the UK government to NI is necessary.

## 2.4 Immigration and the Right to Work

The UK government has signalled that control of immigration is one of the factors motivating a hard BREXIT and that it is the primary motivation for leaving the Single Market. For NI, this presents two challenges. The first is quite unique to NI, the issue of cross-border workers. This is a significant issue but one for which there are possible solutions. The second is a broader issue which will impact all areas of the UK, namely how a decrease in inward migration will affect the labour market and the economy's future growth path.

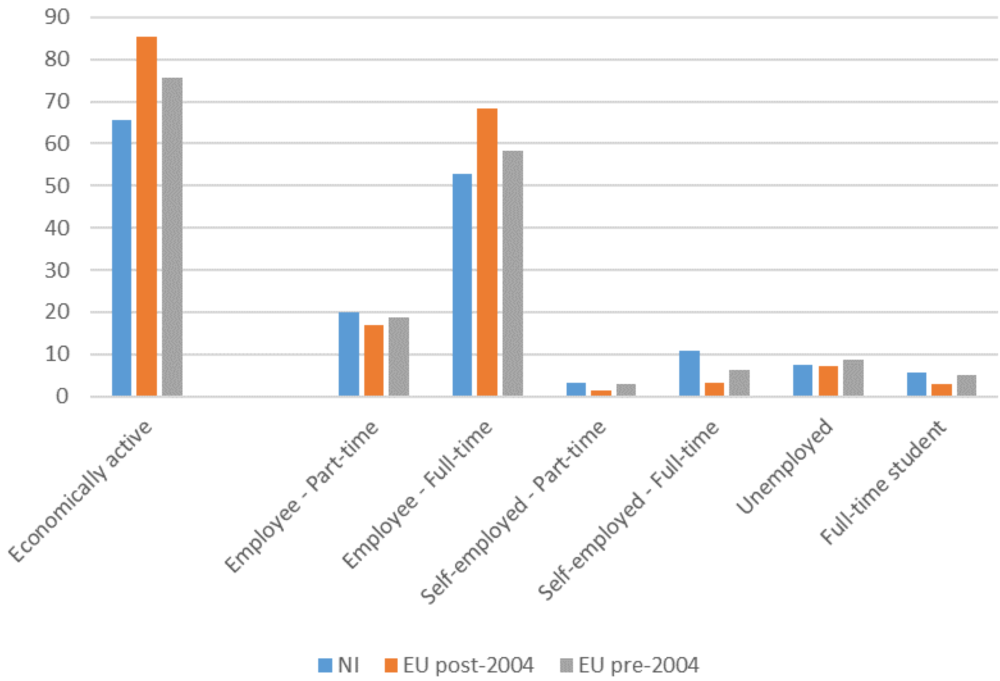
According to figures produced jointly by ROI Central Statistics Office and the NI Statistics and Research Agency, 14,800 people commuted everyday between ROI and NI in 2011. Whilst a greater number of people commuted from the Republic to NI, proportionally more people travelled from NI to the Republic. In both cases over 95% of those commuting cross-border were born either in ROI, NI or GB. Guaranteeing the rights of people in ROI to live and work in the UK and vice versa should not be that difficult, but the EU would have to approve a reciprocal arrangement for UK citizens in ROI. Reaffirming the Common Travel Area should not be that difficult either. The UK and ROI already cooperate on controlling the entrance of some non-EU citizens and furthermore Crown dependencies such as Guernsey and Jersey are members of the CTA without being members of the EU. Preventing EU workers using the border on the island of Ireland as a backdoor into the UK should be about as feasible as it is at present to prevent non-EU citizens doing the same. However, the proposed changes to UK immigration policy are not an issue solely about the border, they have significant implications for the NI economy itself.

NI, along with most other western European countries, experienced a significant level of inward migration from eastern European countries that joined the EU in 2004. Net migration into NI from outside the UK has been relatively modest in these years, reaching a high point of just under 10,000 in 2006/07, turning negative during the crisis years and settling within a range of +2,000 to -3,000 in the last number of years.

However, if the UK government seeks to significantly limit the number of EU migrants allowed to work in the UK this will impact the NI economy . The economic profile of NI residents born in other EU countries looks significantly different to NI born residents.

NI residents from post-2004 EU member states have an economic activity rate of 86% compared to 65% for NI born residents and 75% for pre-2004 EU born residents. Post-2004 EU migrants are also much more likely to be employed full-time and slightly less likely to be unemployed. Pre-2004 EU migrants are the most likely to be unemployed. These figures are important because NI has historically suffered from a low rate of economic activity and inward migration from the EU has actually improved this situation.

### Chart 2.4 Economic Status of Northern Ireland Residents by place of birth 2011

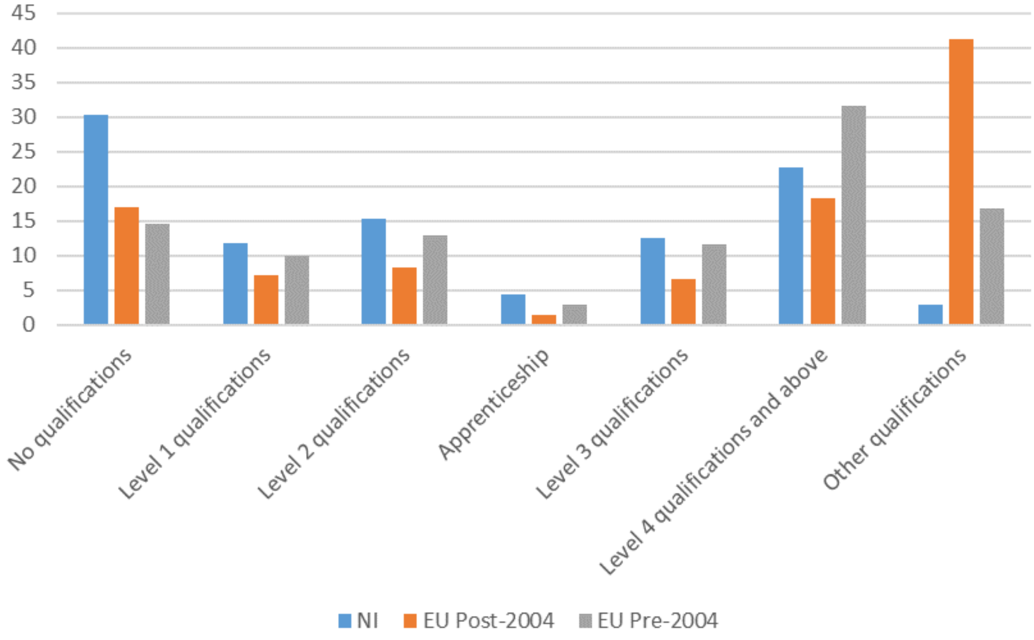



**Sources:** NISRA Neighbourhood Statistcis
**Notes:** EU figures exclude ROI and GB

In terms of skills EU migrants also play a role in lifting the performance of the NI labour market. NI's skills shortage is another long-standing economic impediment. Chart 2.5 shows that EU migration actually improves NI's poor performance on skills. NI born residents are twice as likely as EU born residents to have no qualifications. The proportion of residents born in pre-2004 EU member states that have no qualifications (14%) is only slightly lower than that of post-2004 EU member states

(16%). Most post-2004 EU migrants have 'Other qualifications', but pre-2004 EU migrants outstrip NI born residents in level 4 and above qualifications. Whilst many of these skills are not fully utilised they represent a productive capacity within the labour market.

### Chart 2.5 Economic Status of Northern Ireland Residents by place of birth 2011




**Sources:** NISRA Neighbourhood Statistcis
**Notes:** EU figures exclude ROI and GB

Too often the issue of post-BREXIT immigration in NI has been dismissed merely as an enforcement problem due to the land border with ROI. What these statistics show is that two of NI's most persistent labour market weaknesses would be exacerbated by a fall in inward migration from the EU. The Northern Ireland Executive should make clear that it is their intention to preserve the rights of existing EU migrants in order to prevent an exodus of much needed workers and skills.

## 2.5 Conclusion

The exact shape of the UK's future relationship with the EU remains as indecipherable as it was on June 24th. There are many choices facing the UK government in this regard once they invoke Article 50 of the Lisbon Treaty and the clock begins to tick on the process of leaving the EU begins. Each one of these decisions will have significant implications for the UK economy as a whole and a particularly significant impact on the NI economy.

The fall in the value of sterling may give short term comfort to exporters, but other areas of business, workers and consumers are likely to be negatively impacted in the medium to longer term. The Single Market is vitally important for future trade with the EU, but there is little justification for NI remaining in the Single Market alone. Leaving the customs union poses a unique threat to cross-border trade on the island of Ireland and is more likely to have a more immediate impact than leaving the Single Market. An economic case can be made for NI alone remaining within the Customs Union, but it is a weak one. Finally, inward immigration from the EU has benefited the NI labour market and any proposed reduction in immigration levels would entrench existing structural weaknesses.

Overall a Hard BREXIT is likely to be more economically disruptive for Northern Ireland. Remaining within the Single Market and most importantly the Customs Union would be the optimal situation for NI. The Northern Ireland Executive must recognize the impact that BREXIT has had on the NI economy already and prepare for the implications of what is to come.

**Nevin Economic Research Institute (NERI)**

31/32 Parnell Square
Dublin 1
Phone + 353 1 8897722

45-47 Donegall Street
Belfast
BT1 2FG
Northern Ireland
Phone +44 28 902 47940

Email: info@NERInstitute.net
Web: www.NERInstitute.net