Brexit watch

Fortnightly briefing on Brexit developments

In this issue

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- David Davis appears in front of the Brexit Committee
- UK-France Summit sees Macron hold firm on financial services trade deal conditions
- EU Debt-to-GDP figures released for Q3 2017.

The 20th issue of Brexit Watch marks the first fully redesigned publication for EY-DKM Economic Advisory Services, and allows pause for thought as we face into the final full year of negotiations before Brexit comes into effect. The volume of commentary dedicated to the uncertainties of Brexit and contradictory forecasts has arguably been surpassed by the political theatre and discord that has enveloped many debates.

Brexit by nature, is the rejection of a political ideology and will doubtlessly provide much for political scientists and sociologists to incisively question. However, for businesses and European employees, concrete progress offers much greater value.

As we near the end of January, economic indicators for Q3 2017 have painted a positive picture of GDP growth both in Ireland, and across the EU. Employment and inflation data for the EU and UK were released over the last week. The UK's Consumer Price Index (CPIH) continues to report the issue of high inflation (2.7% annually), but is seeing the start of a desired falling trend. In comparison, Ireland lags far behind with one of the lowest figures (0.4% annually) in the EU28 which is equally problematic.

Inflation growth has a direct impact on real wages, which is problematic for different reasons in the UK. In spite of the contrasting trends observed in the UK and Ireland, both are measuring strong growth in employment, with forecasts suggesting that the two labour markets will reach full employment this year.

Many have argued that a transition phase could help maintain positive trends in these figures, and provide industries with the confidence to keep growing their workforces. However, much will depend on the decisions taken in 2018.

On Thursday, at time of writing, the Chair of the Brexit Select Committee Hilary Benn is in Dublin to speak at a Brexit Conference and to conduct a fact-finding mission, having visited the Border before Christmas. Reflections on the DCU Brexit Conference, and on the World Economic Forum in Davos will be provided in Issue 20 of Brexit Watch.

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1 Political developments

Ireland

Taoiseach presents first speech to the European Parliament

In his first speech to the European Parliament, Taoiseach Leo Varadkar was welcomed with applause as he opened debate on the future of Europe. In response to Mr Varadkar's comments, Chief Brexit Coordinator for the European Parliament, Guy Verhofstadt, reiterated that the Irish position will continue to also be that of the EU in all upcoming Brexit discussions.

Mr Varadkar spoke on the future of Europe and in doing so highlighted Ireland's unique history as a proponent of the union and its endeavours and has drawn comparisons with French President Macron for his pro-Europe outlook.

Phase two of negotiations will deal with the future trade relationship post-Brexit, which has potential to pose one of the more substantial economic threats to Ireland. With Theresa May following the mantra of 'no deal is better than a bad deal', the Taoiseach has aligned himself closely with EU leaders, in an effort to keep the Irish narrative at the forefront of discussions.

In a further boost for the Fine Gael leader, the most recent Irish Times/Ipsos MRBI poll attributed a voter approval rating of 60 per cent to Mr Varadkar, after a gain of seven points since the end of the previous year. This represents the highest leader approval rating since Bertie Ahern in 2007, pre-crash. The strong national support will further cement the Taoiseach's position in Europe as a leader to be listened to, and as having the country's backing.

Sinn Féin

At home, the Sinn Féin party begins a generational shift, as Mary Lou McDonald has been confirmed as the uncontested, new leader of the party. Ms McDonald will take over from Gerry Adams, party president since 1983.

Ms McDonald was long tipped to ascend to the role, having defended Adams repeatedly since taking her seat in the Dáil. Mr Adams emphasised the change in leadership as being part of a greater ten-year plan 'for the regeneration and renewal of the party.'

The position of deputy is yet to be officially decided but potential candidates, including Pearse Doherty and Matt Carthy, have announced they will not run, leaving the path clear for a now unchallenged Michelle O'Neil, party leader in the North.

Sinn Féin remains strongly opposed to a hard border post-Brexit and will likely seek legal confirmation of this as talks progress.

Economic Performance

Recent Statistics

European Union

Government debt continues to fall across the EU (24th January, eurostat)

- 2017 Q3 figures show government debt to GDP ratio fell to 88.1% from 89.0% on the previous quarter (euro area 19).
- Ratio fell to 82.5% from 83.3% (EU 28) over the same period.
- December figures for the annual inflation rate in the euro area fell to 1.4% from 1.5% in November.
- The EU annual inflation rate fell from 1.8% to 1.7% over the same period.
- The ECB aims for a rate below, but close to 2% over the medium term.

Great Britain

Labour market statistics released (24th January, ONS)

- Employment rate for September to November grew by 0.2% on the previous three months to 75.3%, an increase of 0.8 p.p on the previous year. This is the joint highest figure since this statistic was first recorded in 1971.
- Average weekly earnings (including bonuses) in nominal terms increased by 2.5% year-on-year.
- Average weekly earnings (including bonuses) in real terms i.e. adjusted for inflation decreased by 0.2% year-on-year.
- CPIH annual inflation rate fell to 2.7% in December, down from 2.8% in November.

Republic of Ireland

New labour survey replaces QNHS employment figures (January 16th, CSO)

- The Labour Force Survey has released figures for 2017 Q3. Employment increased by 2.2% year-on-year, or 48,100.
- Annual manufacturing industries Output Price Index increased by 0.4% from November to December 2017. The year-on-year change was -3.6%. This is largely attributed to decreases in pharmaceutical and chemical product manufacturing prices.
- The CPI recorded an annual increase of 0.4% in December 2017.

Northern Ireland

Unemployment rate reaches 10 year low (January 24th, NISRA)

- The Labour Force Survey was released for Q3 2017 and shows a 10 year low of 3.8% unemployment.
- The Northern Ireland Composite Economic Index shows year-on-year growth in economic activity of 1.2% from Q3 2016 to Q3 2017.
- The volume of construction increased by 1.2% from Q2 to Q3 2017. The year-on-year increase was 11.3%.

1 Political developments

United Kingdom

UK-France Summit

Prime Minister Theresa May has welcomed French President Emmanuel Macron to the UK, on his first presidential visit. The UK-France Summit 2018 offered both leaders a chance to discuss the post-Brexit relationship before official negotiations resume this spring.

Macron has previously posited himself as a strong proponent of an increasingly connected and unified Europe, and reiterated the EU's stance on a post-Brexit, financial services deal. Macron explained that the City would not have access to a special trade deal without remaining a part of the Single European Market, or by means of a financial contribution from the UK itself.

He explained; 'I want to make sure that the single market is preserved because that's very much the heart of the EU… There can be no differentiated access to the financial services. If you want access to the single market, including financial services… you need to contribute to the budget and acknowledge the European jurisdiction.'

Davis appears before Brexit Committee

On Wednesday David Davis appeared before the Brexit Select Committee to provide an update on his and the Government's latest thinking on the Brexit question. In an at times tetchy exchange, Mr Davis was challenged on his vision, arguing with both Labour and Conservative MPs, including Jacob Rees-Mogg, an ardent Brexiter, who asserted that if the UK remains subject to the jurisdiction of the ECJ after March 2019 it would become a 'vassal state'.

Mr Davis also contradicted his own views expressed in an article he wrote in June 2016, where he had argued that the UK could negotiate a bigger free trade area than the EU in under two years, stating 'that was then and this is now'.

UKIP leader fights to retain position

UKIP's leader Henry Bolton, the fifth in 18 months, has received a vote of no confidence from the party's National Executive Committee (NEC).

While Bolton, elected last September, has been criticised for his lack of political experience, recent events have been catalysed by racist comments made by Bolton's partner. Bolton has rejected the vote and suggested that should he leave, it will be the end of the party.

Former leader Nigel Farage has provided measured support to Bolton, and joined him in criticising the NEC as a body needing reform. Having campaigned on the promise of Brexit for the last two decades, some commentary has suggested the party has not adequately defined its place in British politics now that its chief campaign issue has been addressed.

European Union

Germany moves closer to securing a government

While Germany is still without an operational government, four months after its general election, strides were taken on Sunday to secure a coalition between Angela Merkel's Christian Democratic Union (CDU) and Christian Social Union (CSU), and Martin Schulz's Social Democrats (SPD). Following an initial reluctance to engage in discussions, the SPD narrowly voted to open formal coalition talks with just over 56 per cent in favour.

The vote comes after the party lost substantial ground in the September election, and decided against joining Ms Merkel in government. The sustained deadlock has afforded the SPD greater bargaining power in discussions which they will likely utilise going forward.

The relatively low 56.4 per cent majority vote highlights underlying concerns with regard to how the SPD is moving forward. If talks progress as planned, a new coalition government could be established by Easter.

MEPs vote to decrease the size of the European Parliament post-Brexit

When the UK officially leaves the EU next year, it will no longer require the 73 parliamentary seats it currently holds. The remaining 27 countries have voted this week to reduce the size of the European Parliament to 705 members, from 751. The remaining 27 seats will be reallocated amongst the remaining member states.

Ireland is due to gain a further two MEP positions. The proposal was passed by the Constitutional Affairs Committee with a vote of 24 to 4 in favour, following extensive debate on the topic in recent months.

Northern Ireland

Talks to resume to re-establish NI government

Tensions remain high in Stormont, however both the DUP and Sinn Féin will renew efforts to reach a compromise on power-sharing as talks resume this week. In light of phase two negotiations, both the British and Irish governments share keen interests in facilitating a resolution, which has left the North without a functional government for the last 12 months.

Raising funding concerns with the Northern Ireland Affairs Committee in Westminster, Head of the Civil Service David Sterling noted that without a budget for the next financial year, it is difficult to determine which public services can and cannot be delivered in the North.

Mr Sterling has identified February 8th as the date by which certainty will be needed. Negotiations began yesterday and will continue for the next fortnight, with the place of Irish language remaining a key issue to be resolved.

2 Economic Updates

Government debt across the euro area continues to decrease

Eurostat has released government finance figures for Q3 2017 which show that in both the euro area and the EU28 the debt to GDP ratios are falling as is generally expected at this point of the business cycle. While they still remain strikingly high relative to pre-crash levels, the trend nevertheless is falling as is preferred.

In this scenario, 'debt' refers to loans, currencies and deposits, and debt securities.

What does the data show?

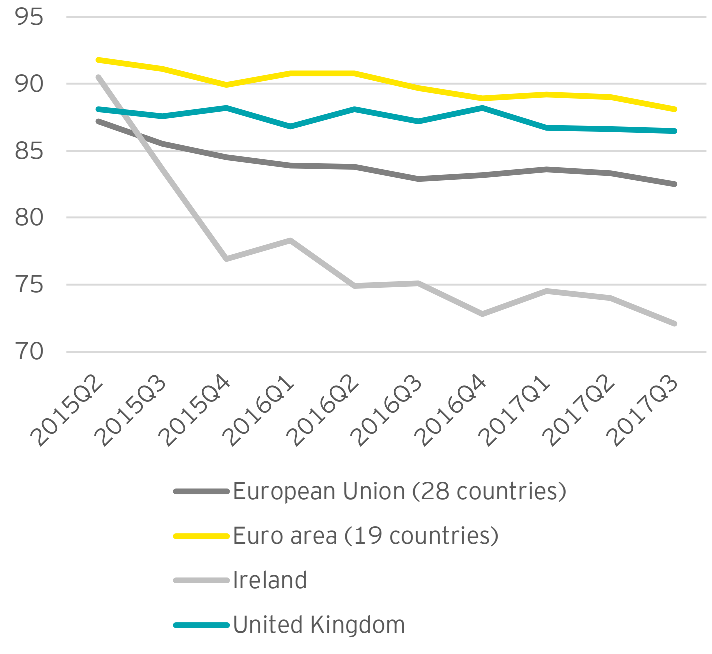

Figure 1: Government Debt to GDP Ratio, 2015 Q2 to 2017 Q3.

Source: Eurostat

The most recent data available is for Q3 2017, and shows Ireland to be in a relatively strong position when compared with both the EU average, and the euro area average. Over the past two years, Ireland's ratio has fallen significantly from 90.5 per cent debt to GDP in Q2 2015, to 72.1 per cent in Q3 2017.

Considering Ireland's starting point, and the fact that five EU countries still have ratios greater than 100 per cent, the development in Ireland's position is positive in light of Brexit.

This is largely due to the spectacular growth in GDP and, whilst welcome, it is important to remember that debt per person is still amongst the highest in the world.

After Ireland meets its medium-term objective (MTO) and achieves a structurally balanced budget, as is expected this year, a continued decrease in the Irish debt to GDP ratio will not equate to additional fiscal space to protect against economic contraction. However, having met the MTO will provide some budgetary breathing space, in theory.

Criticisms of the ratio:

- The structure of debt cannot be inferred from the aggregated figure. The total government debt can be, at the first level, broken down into three main categories, currency and deposits, debt securities, and loans. The ratio in its most commonly used form simply looks at the aggregated figure.

This poses the following problem:

- The ratio does not have the capacity to differentiate between when the loan proportions of the aggregated debt are due. For example, if debt levels are similarly high in two countries, the state with more short-term repayment dates will respond very differently in its fiscal planning, to the one whose debts are due in the long term. Therefore, over interpreting the headline figure can produce a cloudy picture of the fiscal adjustability.
- The discussion surrounding Ireland's ratio figures over time holds the assumption that GDP as a measure is reflective of Irish economic activity. It has been a topic of debate for many years, and following revisions to the measurement methodology in 2015, was found to be highly distorted by both multinational, and aviation leasing activity.

Consequently, the CSO developed GNI* in an effort to remove these distortions when reporting the output of the economy.

Ireland is a unique case in this way, so the issue must be borne in mind when the ratio is used for comparative purposes across the EU.

That said, Ireland's GDP is likely to be greatly inflated by the aforementioned activity. Therefore it is important to look beyond this alone when determining economic preparedness for potential Brexit shocks.

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