The Potential Impacts of Sterling Depreciation under No Deal

1. The Department for the Economy has recently published a paper on NI Trade and Investment in a no deal scenario.[1] Following the publication of this paper stakeholders asked for further information on the potential impact of depreciation of Sterling on the NI economy.

2. This paper is a consideration of the impact on the NI economy (businesses and consumers) of a *potential* depreciation of Sterling. The NICS does not predict currency movement and this paper should not be taken as a prediction that Sterling will depreciate. In this paper we bring together a range of evidence around the potential impact a depreciation of Sterling might have on the NI economy.

3. Furthermore, this paper does not represent the NICS's view on matters of policy around EU Exit. It simply sets out the evidence for stakeholders to use. A decision on policy would clearly be for a Minister to consider.

Summary

4. A weaker Sterling has traditionally been seen as good for exporters and bad for importers. However, the structure of the NI economy and exporting/importing patterns mean that this simplistic analysis does not capture the full intricacies of all-island trade as it currently operates. Over half (55%) of NI exporters also import, as such it is difficult to be definitive about the impact on NI exporters as this will also depend on the increased cost of goods/services they import, the extent of their importing activity and the balance of their sales between the domestic UK market and export markets.

5. While depreciation of Sterling has been beneficial to the agricultural sector, due to the fact that producer prices and direct payments have increased when Sterling is weaker against the Euro, there is some reason to doubt whether any depreciation of Sterling following a no deal exit would have the same effect. The exchange rate for 2019 direct payments which will be made from October 2019 onwards will be set according to the average exchange rate in September 2019 and as such future falls in Sterling will not be carried through in direct payments to farmers in 2019. Given the high tariff and non-tariff barriers to the EU market in a no deal scenario, it is difficult to anticipate that past benefits for exports in this sector from a weaker Sterling which translated into higher producer prices would materialise.

6. Depreciation in the value of Sterling would also make household goods imported into NI more expensive. Over time this is likely to result in higher rates of inflation, or if such rises are not tolerable, possible action on monetary policy through, for

[1] Department for the Economy, NI Trade and Investment Data Under No Deal

example, interest rates rises. Spending patterns of households in NI have been relatively more affected by inflation compared to other regions of the UK in the past three years, as NI households spend relatively more on food, clothing and fuel which are high import share product groups. As such, if past experience of inflation is replicated, NI may be more affected if the rate of inflation increases following a no deal exit.

7. Tourism and cross-border shopping are two areas that have also traditionally benefitted from weaker Sterling. However, again it is difficult to be definitive that past benefits would be replicated in a no deal context. Pressure on NI households' spending power may also mean that the traditional benefits of increased UK households holidaying within the UK may not materialise. In addition, while depreciation of Sterling could increase the number of Irish residents shopping in NI, this is also likely to be complicated by potential cost increases of imported goods in NI, and uncertainty around customs and VAT requirements when bringing goods back over the border.

8. In addition, for migrant workers the depreciation of Sterling could impact on the attractiveness of taking up employment opportunities in NI to fill vacancies and skills shortages. The data show that to date fewer EU26 migrants are working in Northern Ireland and this could be further compounded under a no deal scenario.

9. Although generally stable in recent decades, inflation is a traditional enemy of macroeconomic stability. For the economy as a whole, the risk of increasing inflation and dampening consumer spending means that depreciation of Sterling is likely to be a further risk to the NI economy of a no deal exit.

Background

10. Immediately after the EU referendum there was a notable depreciation in Sterling, which has shown no sign of recovery in the lead up to the UK's exit from the EU. Figure 1 illustrates Sterling exchange rate index before and after the EU referendum.

Figure 1: Sterling exchange rate index[2]

11. It is difficult to isolate the impact that recent depreciation has had on the economy from general uncertainty around EU Exit. However, we regard the weakness of Sterling, and the rise in inflation as one of the factors in recent worrying signs within the economy. For example, most recent PMIs (Purchasing Managers' Index) for NI suggest that export orders have been declining, manufacturing output has been declining, employment falling (albeit employment figures tend to lag behind other economic indicators), new orders and business output has been falling and service orders declining.[3] We anticipate that any depreciation of Sterling that occurs after a no deal exit could have even more serious consequences, as it will be in the context of higher barriers to NI's largest export market.

12. Given that the likelihood of a no-deal exit has led to a marked depreciation of the Sterling exchange rate[4], there is a risk that there could be a further depreciation in Sterling if the UK leaves the EU without a deal, although the scale of this is difficult to quantify. Any depreciation in Sterling, setting aside any new tariff exposure on exports, would make NI goods cheaper for foreign businesses and consumers, and make foreign sourced goods more expensive for NI businesses and consumers. It could also impact, for example, on internationally traded commodities, often priced in US Dollars, whether or not produced inside or outside the UK. This will also impact all those in NI who consume products which are imported.

[2] Bank of England database
[3] Ulster Bank, Purchasing Managers Index July 2019
[4] Bank of England, Monetary Policy Summary and Minutes, August 2019.

Exports

13. Whilst importers will face increased costs of production, in theory those who export should experience an increase in demand for their product as non-UK importers take advantage of UK goods being relatively less expensive (setting aside any cost consequences from new tariff and non-tariff barriers). Assuming they have no reliance on imports in the supply-chain and they do not increase the price of their goods in response to a drop in the value of the pound, this could result in increased sales and revenue. However, in reality many firms who export rely on intermediate imports, even if this is only energy rather than raw materials, and research[5] by ONS shows that after the referendum there was a tendency for firms to increase the price of exports to take advantage of a weaker Sterling rather than expand production; thus partly negating the relative currency advantage. In addition over half of NI exporters also import (55% in 2017 or 5,318 businesses out of a total of 9,683)[6] and so for these firms any depreciation in Sterling will bring with it some combination of both upside and downside.

14. Whether exporters benefit from a weaker currency will also depend on the scale of tariff and non-tariff barriers they face in a no deal scenario. The scale of these will depend on the type of good or service being exported and the destination country. While this will vary from business to business, overall the majority of NI's exports go to countries within the EU (57% in 2017)[7], with Ireland being our most prominent trading partner. Therefore, unless there is a dramatic shift to trading with other non-EU countries subject to more favourable trade deals, it is likely that a large portion of NI exporters will face an increase in costs which is likely to erode gains from a weaker Sterling.

15. Furthermore, depending on the product they are selling, exporters who also supply domestic markets locally or within GB could face increased competition from rest of the world imports as the UK's temporary tariff regime is implemented. Whilst this could be of benefit to consumers, with an increase in supply and competition lowering the price of some goods, overall this is likely to have a damaging impact on businesses, most of whom will already be dealing with the negative impacts of currency depreciation.

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[5] ONS, The Impact of Sterling Devaluation on Prices and Turnover in the Manufacturing Sector
[6] NISRA, Broad Economy Sales and Exports Statistics (BESES) 2017.
[7] NISRA, Broad Economy Sales and Exports Statistics

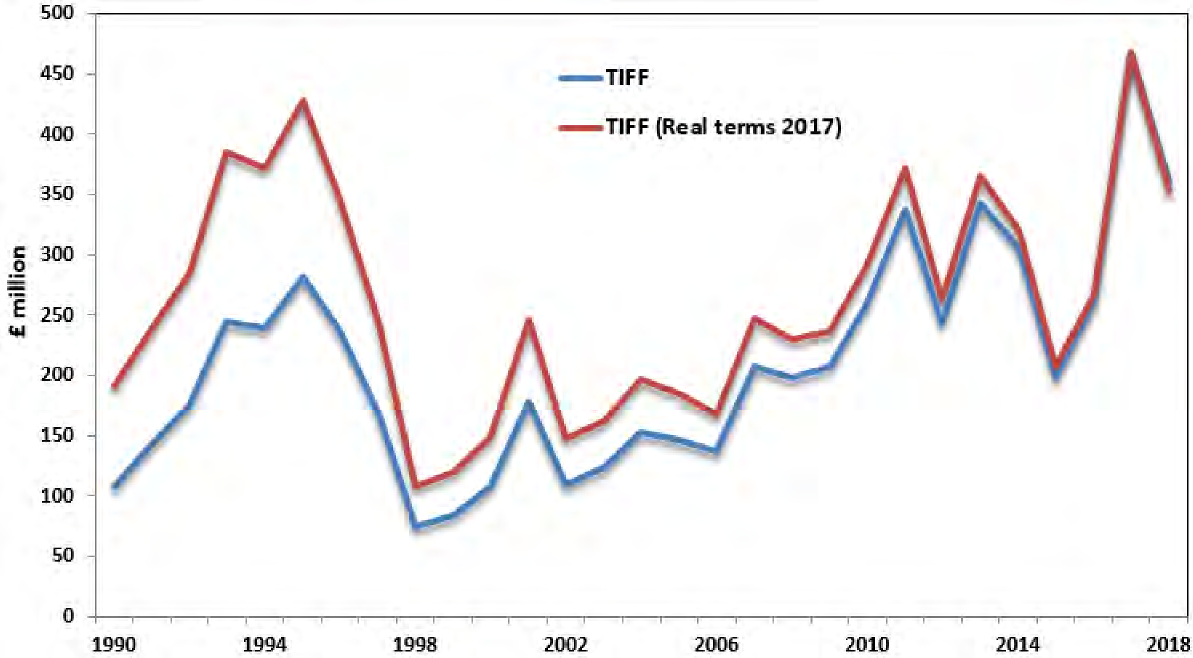
Agriculture

16. Generally there has been a strong correlation between the strength of Sterling (versus the Euro or European currencies) and farm incomes. Periods of weak Sterling have been associated with high farm incomes whilst a strong Sterling has depressed them. This was due to a number of factors. Farm support prices and most EU market prices are set in Euro. Therefore a depreciation of Sterling increased the Sterling equivalent of both – in other words made our exports to the EU more competitive and imports from the EU more expensive which translated into an increase in producer prices in Sterling terms. Farm support payments are currently set at a fixed value in Euro terms and then converted to Sterling using the average exchange rate in September of each year prior to payment to farmers. Consequently the amount paid to farmers in NI can be variable due to currency volatility. Every 1p move in the value of Sterling against the Euro changes the amount paid by approximately £3.2 million. However, input costs generally rise with a weaker Sterling (especially for feed, fertiliser and fuel given that NI has a high import dependency for these products).

17. In the past the positive impacts on market prices and farm support payments arising from a weaker Sterling outweighed the increase in input costs. There is evidence of such changes occurring since the 2016 EU referendum. Producer prices have increased by 19% since 2016 while input prices have gone up by 7%.[8] Farm support payments under Pillar 1 of the Common Agricultural Policy (CAP) were £51 million higher (21%) compared to 2015[9] – the last year these payments were not affected by the Sterling depreciation after the referendum. Total Income from Farming (TIFF) began to recover in 2016 and the levels recorded in 2017 and 2018 were at recent historic highs (see Figure 2).[10] However this cannot all be attributed to the exchange rate. World markets for key agricultural commodities were depressed in 2015 and 2016 and subsequently recovered. Markets have weakened in 2019 with a resulting squeeze on incomes, particularly in the beef and sheep sector despite the current weakness of Sterling.

[8] DAERA, Statistical Review of NI Agriculture 2018
[9] DAERA, Statistical Review of NI Agriculture 2018
[10] DAERA, Statistical Review of NI Agriculture 2018

Figure 2: NI Total Income from Farming (TIFF) 1990-2018[11]



18. In the event of a no deal EU Exit, some of the previous positive impacts of a depreciation of Sterling on farm incomes may not occur. The presence of high tariffs will mean that most UK agricultural exports to the EU will no longer be competitive on the EU market and therefore higher prices for exports in Sterling terms will not materialise. Most third country markets also have high tariff and non-tariff barriers. A weaker Sterling will, in relative terms, mean more expensive imports of farm produce but the UK Government temporary tariff policy which sees large reductions in tariffs will push prices in the opposite direction. Input prices are likely to rise with a weaker Sterling and given that grain can currently be imported at close to world market levels, UK government tariff policy will have relatively little impact on the price of these imports.

19. Farm support payments for 2019 will be converted to Sterling using average rate in September 2019 so will be unaffected by any depreciation of Sterling occurring from October 2019 onwards. If the current exchange rate of €1 = £0.9155 was the average in September 2019, then direct payments to farmers would be about £7m higher, increasing from £286m in 2018 to £293m in 2019.

20. Therefore although a depreciation of Sterling after EU Exit may still have a beneficial impact on farm incomes, it may not be as great as in the past and is likely to be outweighed by other factors, particularly market disruption.

[11] Real terms 2017 means that the income figures in all other years have been adjusted to take account of inflation between the year in question and 2017.

Inflation

21. A depreciation in Sterling, making it weaker against other currencies, will increase the cost of imports for households and businesses. Consumers will have to spend more to purchase imported goods or substitute these for cheaper domestic products. However, this is not possible for many goods due to their nature, for example many fuels, foods or electrical goods can generally only be sourced outside the UK. Businesses who rely on imports as intermediate goods (goods required to produce a final product) will also be affected, as the cost of production increases. This increase in cost is likely to be passed onto the consumer through an increase in price. Therefore, over time this will result in higher rates of inflation and/or action around monetary policy (such as interest rates rises) to curb increases.

22. The impact of past depreciation of Sterling can be seen in increases in consumer prices in the UK compared to the US or euro-zone area. Figure 3[12] compares consumer prices in the UK, EU and USA between 2015 and 2017. Prior to the referendum, there were no obvious differences in the inflation rates in the three areas. However, after June 2016, when there was significant depreciation of Sterling, a gap emerges as prices in the UK increase more quickly than those in the euro-zone area and the United States.

23. This higher rate of inflation has a negative impact on households, as real income is eroded and disposable income is lower than it otherwise would have been. CEP/LSE research[13] suggests that by June 2017, the average household costs had increased by £7.74 per week through higher prices (equivalent to £404 per year). Furthermore, they estimated that higher inflation had reduced the growth of real wages - equivalent to a £448 cut in annual pay for the average worker.

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[12] Centre for Economic Performance (CEP)/London School of Economics (LSE) research paper - The Brexit Vote, Inflation and UK Living Standards

[13] Centre for Economic Performance (CEP)/London School of Economics (LSE) research paper - The Brexit Vote, Inflation and UK Living Standards

Figure 3: Consumer prices for the UK, Euro area and US 2015-17

24. Table 1 below shows Bank of England (BoE) estimates[14] of the impact depreciation has on inflation. The BoE estimates that a 5% depreciation in Sterling adds 0.9% to consumer prices in the long-term, with some of the biggest increases seen in food, energy bills and import-intensive goods such as laptops and TVs. To put this into context, ONS estimated[15] that the Sterling effective exchange rate depreciated 20% between November 2015 and October 2016, including a record 6.5% fall between June and July 2016 following the EU referendum vote.

[14] Bank of England, EU withdrawal scenarios and monetary and financial stability
[15] ONS, The impact of Sterling depreciation on prices and turnover in the UK manufacturing sector

Table 1: The long-run effect on the level of Consumer Price Index (CPI) component prices

Component	**Effect of a 5% Depreciation**
Food and non-alcoholic beverages	1.3%
Alcohol & tobacco	0.3%
Clothing & footwear	1.4%
Housing, utilities	0.7%
Furniture, household equipment	0.9%
Health	1.0%
Transport (incl. fuel)	1.0%
Communication	0.9%
Recreation & culture	1.0%
Education	0.1%
Restaurants & hotels	0.5%
Misc goods & services	0.7%
Package holidays	2.2%
CPI	**0.9%**

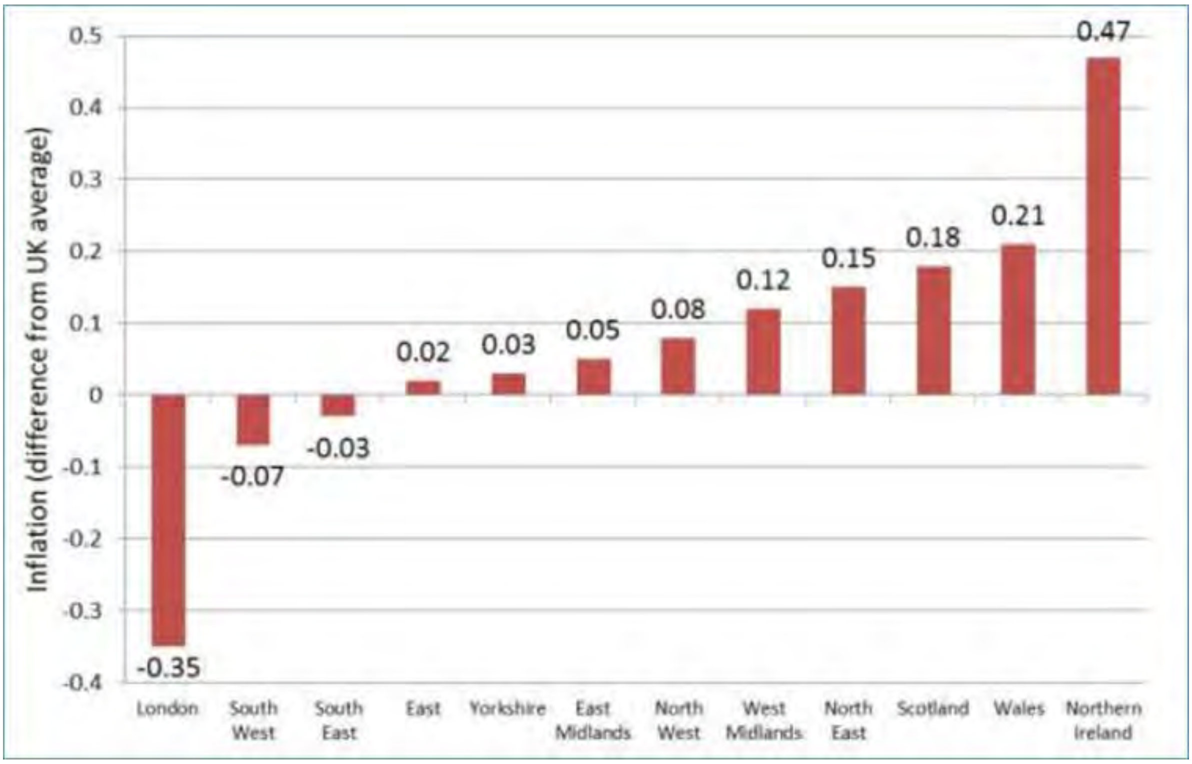
25. Table 1 highlights that depreciation is likely to lead to varying inflation of prices across different goods and services; however, there will also be regional disparities dictated by the nature of goods and services purchased by each region. Figure 2 is taken from the CEP/LSE research, highlighting these regional disparities.

26. As can be seen in Figure 4, Northern Ireland is estimated to have been most effected by inflation following the referendum, increasing by 0.47 percentage points more than the UK average. The research suggests this is because households in Northern Ireland spend relatively more on food, drink, clothing and fuel, which are high import share product groups, and relatively less on rent and sewerage, which have low import shares. The Northern Ireland Retail Study[16] demonstrates that the reliance of the Northern Ireland consumer on external markets for retail products is very high and the Living Costs and Food Survey[17] also shows higher average weekly expenditure by Northern Ireland households on food, drinks, clothing, footwear and fuel compared to the UK average. This would indicate that further inflation/depreciation could have a more significant impact on NI consumers compared to other parts of the UK. Energy prices will be impacted by a number of factors, including foreign exchange movement. The size and timing of any impact

[16] DfE, NI Retail Study
[17] ONS, Detailed Household Expenditure by countries and regions

would be determined by multiple variables, for example: companies hedging strategies.

Figure 4: Inflation differences across regions due to the EU Referendum



27. Research from University of Ulster Economic Policy Centre[18] estimated that NI consumer spending accounted for almost three quarters of overall GDP compared to 65% in the UK. As such, we would be concerned that any drop in consumer spending would have a greater impact in NI than in the UK as a whole.

Interest Rates

28. Inflation is one of the traditional enemies of macroeconomic stability. The main monetary policy lever to address inflation which is higher or lower than the target rate (2% with a 1% allowance either side) is the BoE base rate (interest rates). To control high inflation the BoE's monetary policy committee could decide to increase interest rates which reduces borrowing, as it is more expensive, and increases mortgage repayments for homeowners, resulting in lower expenditure on goods (particularly luxury goods) which has a dampening effect on inflation. However, lower consumer expenditure generally slows the economy, something the BoE could be hesitant to do when there are serious concerns about a possible recession. Either way, household expenditure looks likely to suffer and the BoE's reaction to an increase in inflation will determine the magnitude of this.

[18] University of Ulster, Consumer led growth in an era of squeezed incomes – scoping paper

29. The knock-on effect of this is likely to be pressure on businesses by employees to increase wages to boost their income and keep pace with inflation. Those firms already facing financial pressure from an increase in the cost of production, and possible lower domestic demand for their goods combined with higher costs if the business trades with the EU, are likely to struggle to meet these wage demands whilst also making enough profit to ensure their business remains viable.

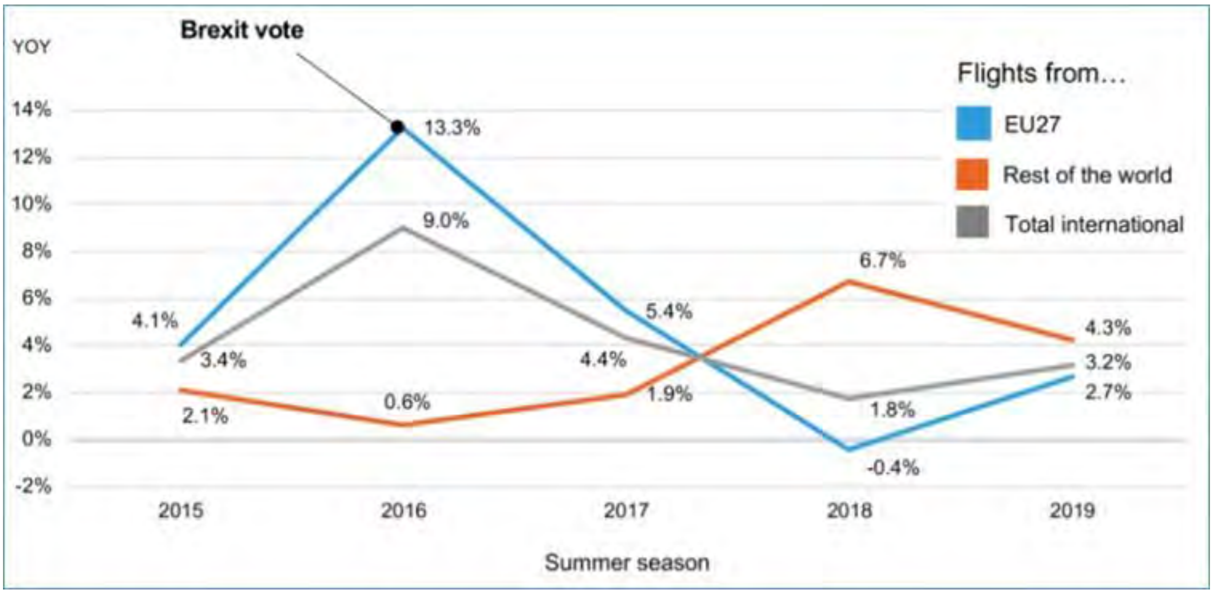
Tourism

30. A weaker pound makes it more expensive for UK citizens to go abroad, as travellers get less foreign money in exchange for Sterling. UK tourists would also likely be exposed to higher airfares, as UK-based airlines would face a rise in their input costs from a weaker pound and would be expected to pass on a portion of this in the form of higher prices. Alternatively, the lower value of Sterling could encourage more tourists to visit the UK as their own currency appreciates. Research[19] by Oxford Economics estimates a no deal Brexit would cause a 5% drop in UK outbound travel and tourism trips in 2020, because of the economic backdrop and impact of a weaker pound. Ireland and Spain would be the hardest hit from fewer UK visitors. In contrast, the weaker pound could mean that UK tourism inflows are 4% higher in a no deal scenario, provided there is no travel disruption.

31. Figure 5 shows the year-on-year change in seat capacity for direct flights arriving in the UK.[20] This shows that the numbers of tourists from the rest of the EU may have declined post-referendum, but are estimated to increase this year. The Euro has been at a relatively lower level compared to pre-recession levels but is slowly recovering, although there is a potential that the Euro could depreciate after the UK leaves the EU. Nevertheless, seat capacity for flights from outside the EU did see a sharp increase post-referendum and was likely to be driven by the weaker pound.

[19] OE Research Briefing UK ((6 December 2018), No-deal' Brexit to knock 2% off travel and tourism GDP
[20] Forward Keys, UK holidaymakers turn away from EU in Brexit limbo. Note 2019 is based on scheduled seat capacity for direct flights.

Figure 5: Seat capacity for direct flights arriving in the UK



32. Alongside additional inbound tourists arriving, there is also the potential for a boost in the number of 'staycations' i.e. those forgoing a foreign holiday to holiday at home. However, Oxford Economics suggest that domestic spending already makes up five-sixths of total spending in this sector and the lower consumer spending power, as a result of depreciation, is likely to result in a lower level of domestic expenditure. As a result, they find that UK travel and tourism GDP will be around 2%, or $6.5 billion, lower (in 2017 prices) in 2020 under a no deal scenario compared with their baseline.

Cross-border travel and shopping

33. Northern Ireland's land border with Ireland provides an opportunity for people to mitigate or exploit notable currency fluctuations which could have implications for the labour market and businesses on both sides of the border. In terms of the labour force, there is a notable volume of cross-border trips made by those who live on one side of the border but work on the other. This is also true for those making crossings which are not work related, including for cross-border shopping. Analysis by the Department[21] estimates the number of annual border crossings to be approximately 105 million. The table below shows the purpose of travel for NI residents who make the cross-border journey.

[21] Department for the Economy, The movement of people across the Northern Ireland – Republic of Ireland border, Research Bulletin 18/5

Table 2: Purpose of travel for border crossings (NI residents)

Average Weekday			
Direction	**Work Related**	**Non-work Related**	**TOTAL**
NI - ROI	32,500	53,600	86,100
ROI – NI	32,400	53,600	86,000
TOTAL	64,900	107,200	172,100
%	62.3%	37.7%	100%
Average Weekend			
NI - ROI	19,900	56,700	76,600
ROI – NI	19,900	57,000	76,900
TOTAL	39,800	113,700	153,500
%	25.9%	74.1%	100%

34. Table 2 shows there are over 30,000 work-related crossings from NI residents on an average weekday. Assuming these people are paid in Euros, the depreciation of the pound would be of benefit, given a favourable exchange rate allows for greater spending power after exchanging currencies. Conversely, Ireland residents travelling cross-border to work in NI who are paid in Sterling will be disadvantaged as a weaker pound purchases less Euros when they exchange money to spend in Ireland.

35. This could encourage more NI residents to work in Ireland and fewer Irish residents to work in NI. NI businesses near the border may also find it hard to compete with Irish businesses to fill vacancies.

36. In addition, the depreciation of Sterling could have an impact on cross-border shopping. In theory, a weaker pound should encourage more Irish residents to make the journey to NI to do their shopping as it should be less expensive than shopping in Euros. However, this is only likely to happen if prices in NI are not adversely affected which, given the impact of depreciation on the cost of imports and inflation, is unlikely to be the case. Therefore, any benefit of a weaker Sterling for Irish cross-border shoppers would be short-lived as the cost of goods and services increase in the medium to long-term. The uncertainty around customs and VAT requirements may also have an impact on the number of cross-border shoppers in NI.

Attracting labour from beyond the UK

37. Northern Ireland has a small labour market. The flexibility which migration provides in terms of accessing skills has been demonstrated through research to be of benefit to the economy. The NI economy as a whole has a dependence on those with a nationality outside of the UK and recent engagement with business

stakeholders highlights that access to skills/labour is a key EU Exit issue for them with access needed to both unskilled and highly skilled labour.

38. Since 2016 Northern Ireland has exhibited a sharp decline in the numbers of EU26 migrants in employment (54,000 to 41,000 in 2018, a reduction of 24%) and while we cannot definitively link the depreciation of Sterling to the reduction, it has likely been a contributory factor to the attractiveness of NI as a destination for migrants. In contrast, during the same period the number of EU26 nationals employed in the Republic of Ireland has increased by 10% from 199,000 to 219,000.

Conclusion

39. This analysis is not a prediction of how exchange rates will vary after a no deal exit, but rather an analysis of the potential impact upon NI businesses, farmers, and consumers of a further depreciation in Sterling.

40. The value of currency used in everyday life will impact all of those using it. The structure of the NI economy, the overall exposure in exports to the EU market, lower consumer spending power, dependence on migrant workers, and the fact of a land border which brings with it cross-border shopping and commuting means that NI is likely to be more exposed and exposed in different ways to the other regions of the UK.

41. Past experience of the benefits of weaker Sterling are not likely to be directly replicable in a no deal scenario for a range of reasons. Benefits for exports will come at the same time as increased costs of exporting to NI's largest export market. Previous benefits to farmers of weaker Sterling are unlikely to occur in the event of a no deal exit. Direct payments will be set at the average exchange rate against the Euro for September 2019 as such, while they may increase on 2018, they will not benefit from any depreciation of Sterling after a no deal exit. This is unlikely to compensate for the significant difficulties the agri-food sector is likely to face in the event of a no deal context in relation to remaining competitive in the EU or GB markets.

42. Consumers are exposed to increases in prices of imported goods such as food, clothing or fuel. Increased prices in these goods is likely to increase the rate of inflation. This is a concern for several reasons, in particular any increases in these goods will have a significant impact on those already on low incomes. In addition, any decrease in consumer spending is likely to impact the overall economy.

43. Overall, further depreciation of Sterling is likely to represent a risk to the NI economy and to those on low incomes in particular. The scale of this risk is likely

to depend on the significance of any depreciation and how this affects expected overall changes in trade.