

UUEPC OUTLOOK WINTER 2022



Global challenges, local consequences

The war in Ukraine is first and foremost a humanitarian crisis for the Ukrainian people, but it has also become a global economic crisis. Given hydrocarbons are the lifeblood of modern society, the sanctions against Russia have increased the cost of energy to unaffordable levels for many households and businesses. As a consequence, governments have stepped in to mitigate the worst impacts of these cost increases.

The resultant increase in inflation has produced the typical response from monetary authorities and interest rates are now at levels not experienced since prior to the financial crisis in 2008. This latest economic shock, just as economies around the world appeared to be recovering strongly from the impact of the pandemic, will push many countries back into recession.

Against this backdrop, the latest UUEPC outlook anticipates an economic contraction next year for Northern Ireland before recovery in 2024.

Key forecasts

Northern Ireland (NI)

	2022	2023	2024	2025	2026
GVA [1] growth rate	2.8%	-1.2%	1.7%	2.3%	1.7%
ILO [2] Unemployment rate	3.9%	4.3%	4.2%	3.7%	3.5%
Jobs growth	3.1%	-0.5%	0.1%	1.1%	1.4%

United Kingdom (UK)

	2022	2023	2024	2025	2026
GVA [1] growth rate	2.7%	-1.0%	1.5%	2.1%	1.8%
ILO Unemployment rate	3.7%	4.4%	5.1%	4.9%	4.3%

Macro-economic variables

	2022	2023	2024	2025	2026
Interest rates [3] (end of year)	3.5%	3.5%	3.25%	3.0%	3.0%
Inflation [4] (annual average)	9.1%	7.4%	3.5%	0.8%	1.8%

Source: UUEPC, OBR

Note 1: Gross Value Added (GVA) is the preferred measure of economic activity. It is similar to Gross Domestic Product (GDP) but excludes the impact of taxes and subsidies (most notably VAT)

Note 2: 16-64 ILO unemployment rate

Note 3: Bank of England Base Rate

Note 4: UK Consumer Price Index (CPI)

Are interest rates near their peak?

In the immediate aftermath of the 'short-lived' mini-Budget, the financial markets anticipated that the Bank of England base rate would need to rise to over 6% to bring inflation back to its 2% target. Then following the policy reversals announced by the Chancellor Jeremy Hunt, the market implied peak interest rate fell to just over 5%.

Members of the Bank of England's Monetary Policy Committee (MPC) have since suggested that even this 'lower' peak rate would create a recession deeper than required to bring inflation back to target. This raises the question around the likely new peak level of interest rates.

Interest rate decisions are based on expectations around the future level of inflation and policy makers are currently considering the following **factors which support further increases**:

- Second round effects – there are concerns that firms are passing on their higher input costs down the supply chain thus raising the Consumer Prices Index (CPI). This in turn results in higher wage demands which will require firms to raise their prices further and, if unchecked, a cycle of higher inflation ensues; and
- Fiscal policy is at odds with monetary policy – government fiscal interventions have been universal in nature at a time when higher income households still have excess savings. This runs the risk of maintaining demand in the economy when the current objective of monetary policy is to dampen demand.

In addition, the following factors suggest the current cycle of **interest rate hikes could be approaching an end**:

- Future energy prices – inflation is not expected to persist in the medium term because energy prices alone make up around 30% of total inflation (Chart 1) and therefore if energy prices fall back, inflation could quickly follow;
- The full impact of interest rate rises still has to feed through to the economy – typically interest rate increases take approximately 12 months to have an

impact on the economy and therefore hikes this year will only impact the economy next year. Given the economy is almost certainly in recession, caused by higher energy prices, further monetary tightening will only exacerbate the slowdown next year;

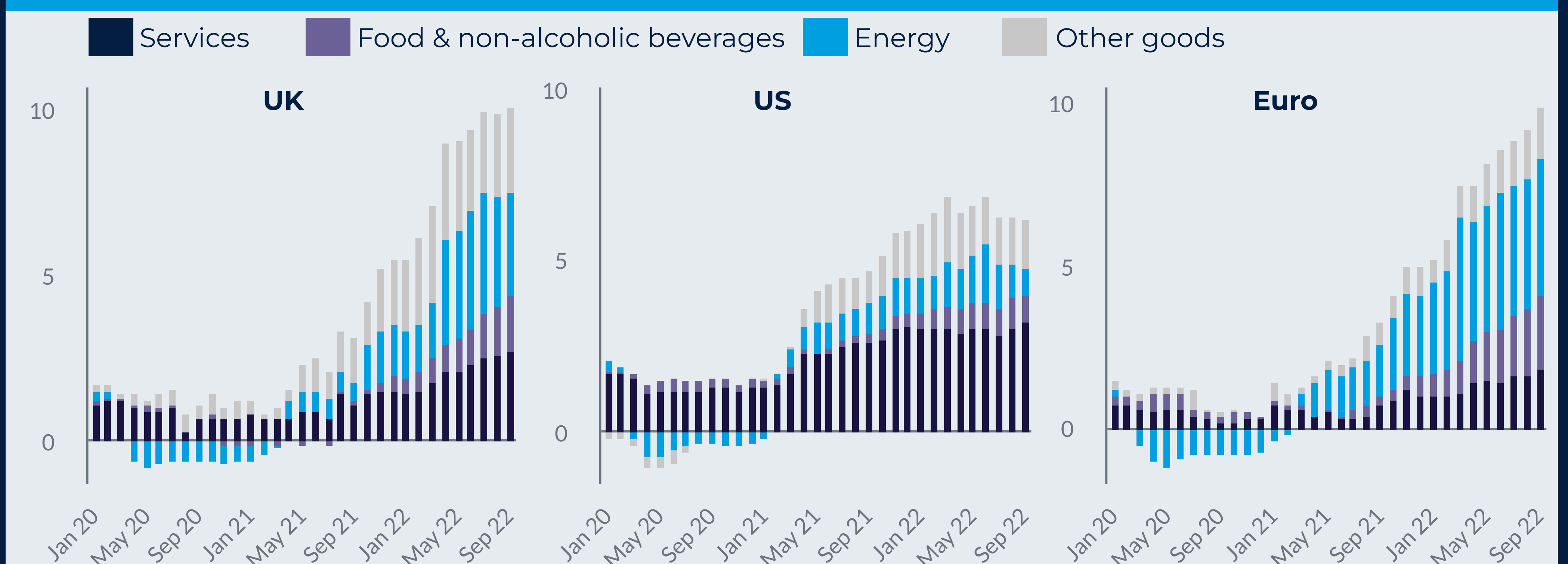
- Ongoing Quantitative Tightening (QT) – the Bank's policy of unwinding its balance sheet is still ongoing and the impact on financial markets of running parallel policies of QT alongside rising interest rates, at a time when the Government is borrowing heavily to support households and businesses, must increase downside risk; and
- Ability of firms to continue to pass-on cost increases – for much of 2022 firms have been able to pass-on their rising costs, but with increased pressure on consumer income, the ability to continue to pass on costs will reduce.

The Bank of England does not provide a forecast for interest rates and their modelling is therefore based on the path of interest rates implied by the financial markets (peaking at 5.25% in 2023). Based on this interest rate path, the Bank forecasts inflation falling to 0.0% by Q4 2025, thus creating a more severe economic slowdown than necessary.

Interestingly, forecasts based on the alternative assumption of constant interest rates (i.e. if they were to stay at 3%) included in the MPC report, shows inflation falling to 0.8% by Q4 2025, also below target. Whilst it is the judgement of the MPC that future inflation risks are skewed to the upside, this suggests that interest rates may be closer to their peak than current market consensus levels.

This view may also be supported by the different drivers of inflation in the UK and EU compared to the US, where energy has a much greater impact on inflation on this side of the Atlantic (Chart 1). Therefore, a reduction in oil and gas prices could see a much more rapid reduction in inflation here and in the EU relative to the US.

Chart 1: Contribution to annual CPI, UK, US and Euro area



Source: Bank of England, MPC report November 2022

The impact of cost increases on businesses and households

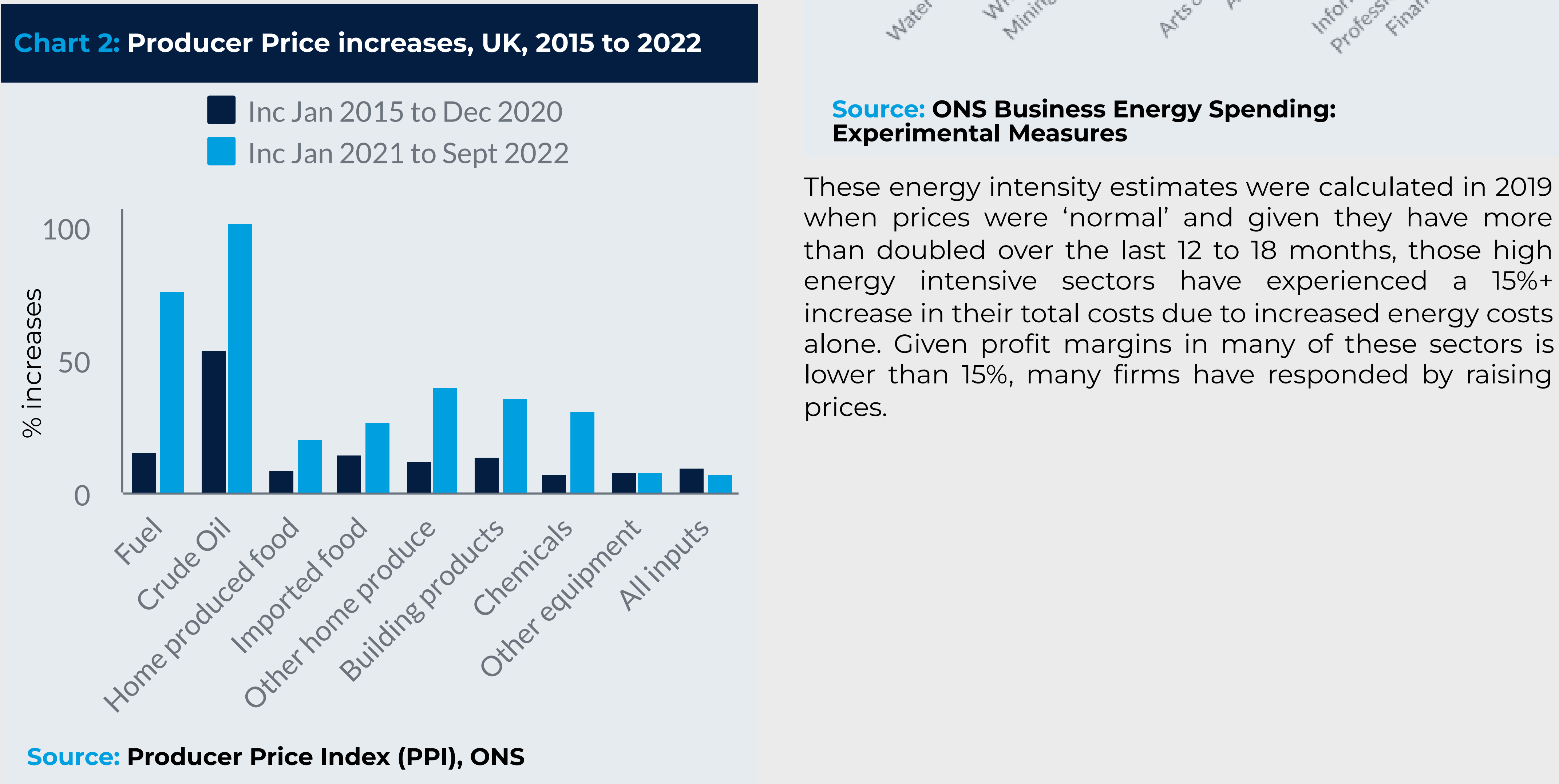
After an extended period of low or no inflation, costs have increased significantly over the last 18 months creating substantial pressures for both businesses and households.

In response, governments have intervened to provide some protections and mitigate the worst impacts of the energy price rises. These supports are welcomed by many but one of the concerns from the Bank of England is that universal support, in particular to those not in greatest need, provides additional consumer spending which could stoke the flames of inflation. Separately, given the state of the public finances, universal support is not affordable and therefore any new government mitigation measures announced must be more targeted.

Business cost increases dominated by energy

Many important producer input costs increased more in the 21 months from Jan 2021 to Sept 2022 than in the previous 5 years from Jan 2015 to Dec 2020 (Chart 2). Fuel and crude oil prices experienced the largest increases, but a range of other inputs also increased significantly including: Food – both home produced and imported; Building products (official title Metals & Non-Metallic Minerals); and Chemicals.

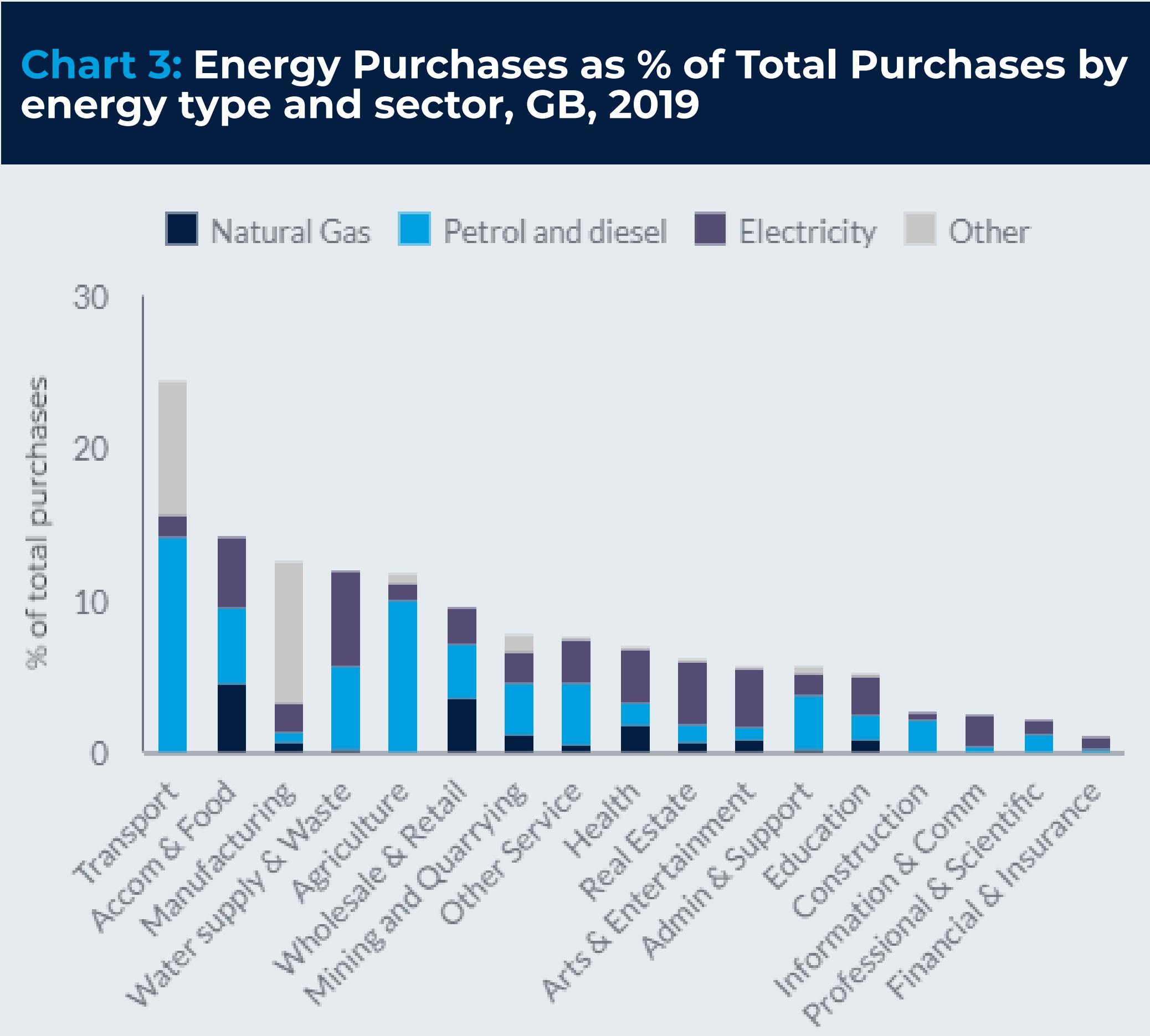
Food prices are increasingly determined on international markets which have been significantly impacted given Ukraine’s status as a major global food exporter. In addition, the cost of many building products and chemicals tend to be linked to energy prices.



Transport, Hospitality, Manufacturing, Utilities and Agriculture most energy intensive

Energy intensity (defined as energy purchases as % of total purchases) across sectors is recognised as being stable over long time periods and the most energy intensive sectors will therefore be most vulnerable to significant increases in energy costs.

Most sectors are reliant on petrol/ diesel and electricity but both Transport & Storage and Manufacturing are also heavily dependent on ‘Other’ fuels which includes kerosene, liquefied petroleum gas (LPG), coal and coke, and other refined petroleum products (Chart 3).



Source: ONS Business Energy Spending: Experimental Measures

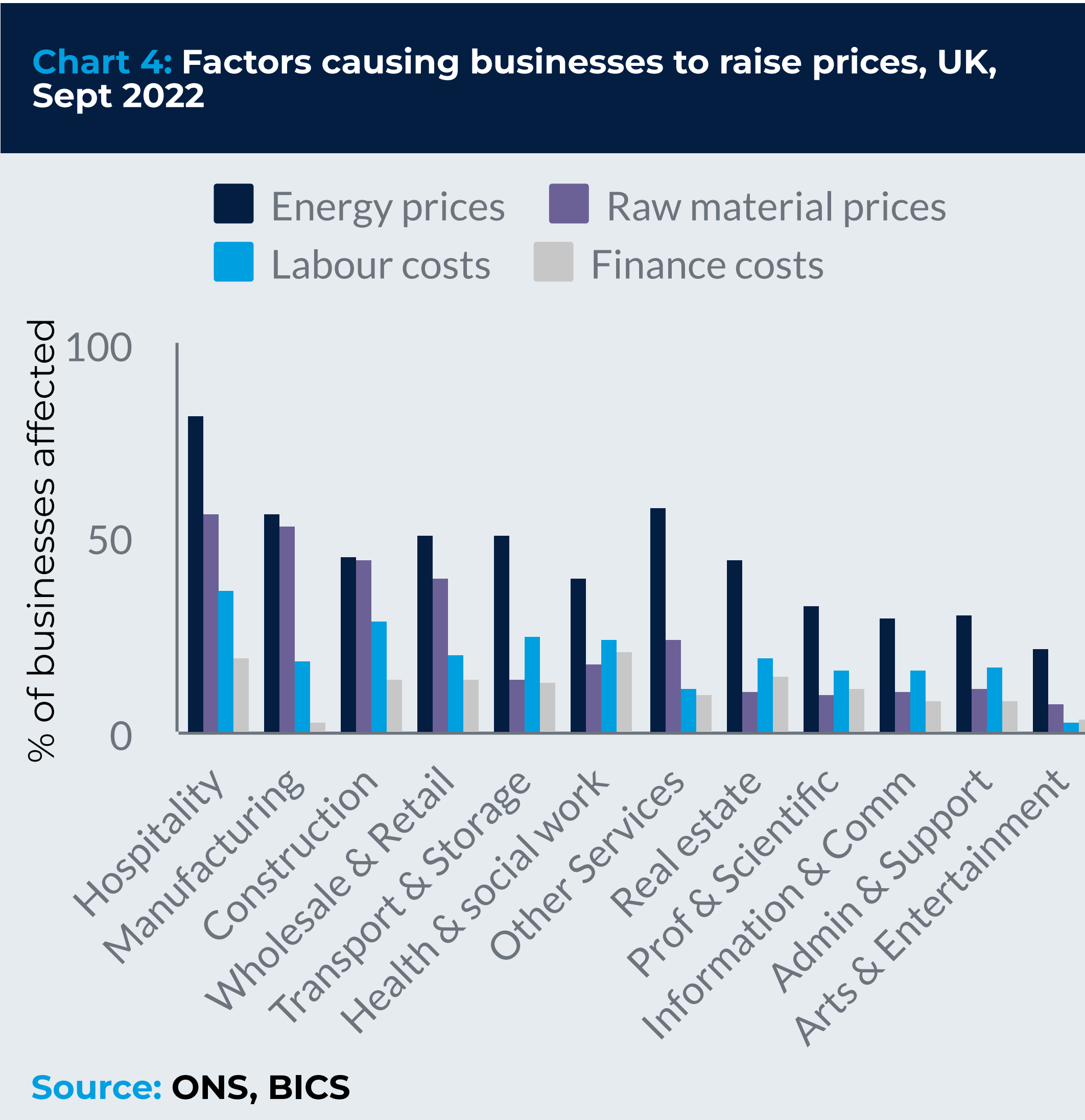
These energy intensity estimates were calculated in 2019 when prices were ‘normal’ and given they have more than doubled over the last 12 to 18 months, those high energy intensive sectors have experienced a 15%+ increase in their total costs due to increased energy costs alone. Given profit margins in many of these sectors is lower than 15%, many firms have responded by raising prices.

Energy and raw materials costs driving higher prices

Energy costs, followed by input/ raw materials costs and labour costs are the key factors causing firms to increase their prices (Chart 4). The following sectors have been most likely to raise prices:

- Accommodation and Food – with 80% of businesses in the sector raising prices due to energy costs; 57% due to input prices (mostly likely food); and 37% due to increased labour costs;
- Manufacturing, Construction and Retail sectors are also highly affected by energy and raw material prices and to a lesser extent (but still significant) labour costs; and
- Transport sector particularly impacted by energy costs.

This ability to pass on cost increases to customers is one of the key concerns of the Bank of England as it contributes to higher consumer prices and hence inflation. Therefore the MPC must make a judgement on the extent to which they need to continue to squeeze the economy to the point that businesses can no longer pass on cost increases. This only becomes apparent after the fact which creates a risk of causing a deeper recession than needed to control inflation.



It is telling that rising finance costs are also being increasingly cited as an issue by firms across all sectors. This reflects higher interest rates but also the increased risks associated with an economic slowdown, where financial institutions will be increasingly wary of the likelihood of higher levels of bad debt, particularly in sectors more reliant on discretionary income.

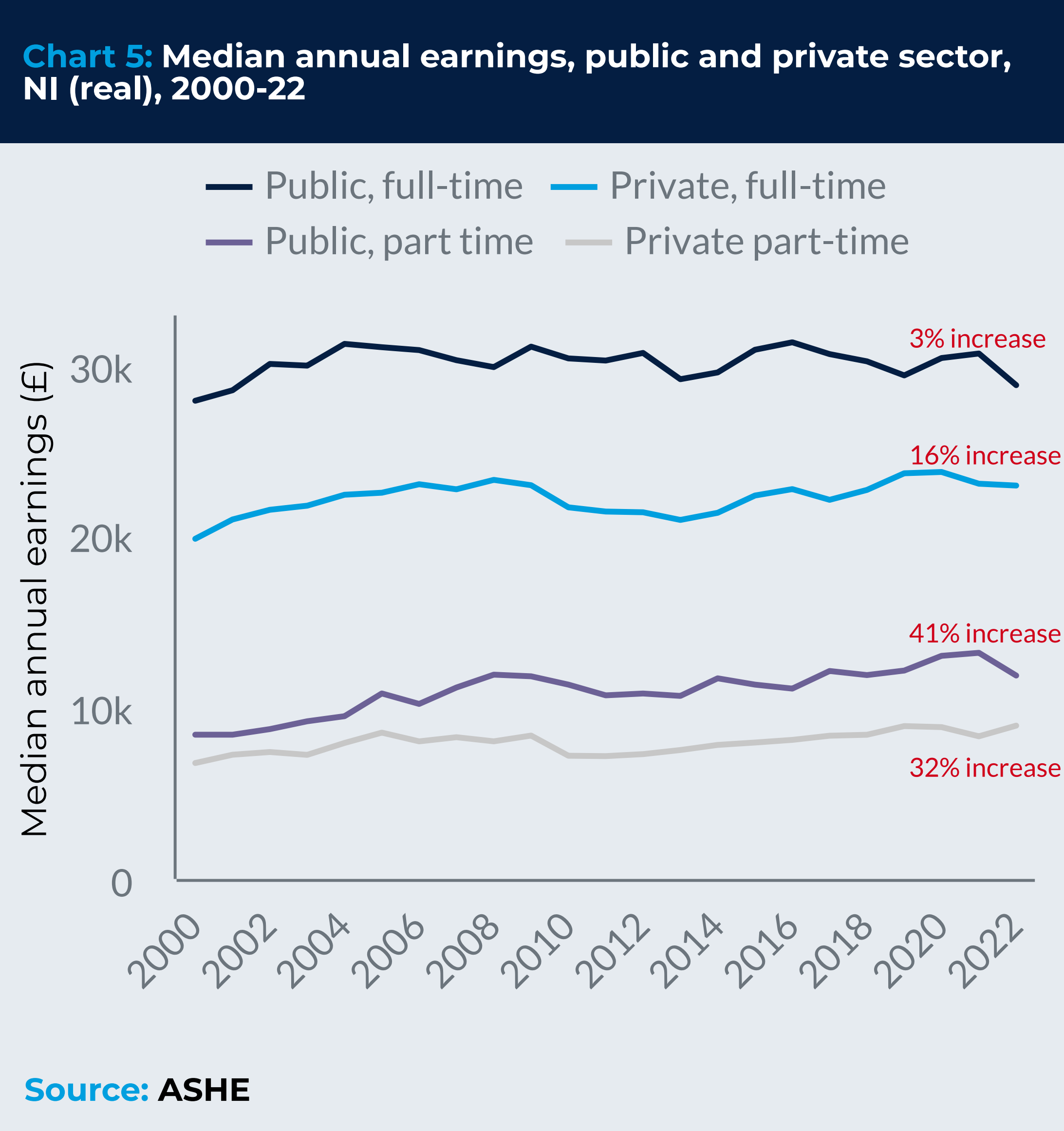
Income growth has been very low for 20 years

The analysis above has shown that businesses are having to deal with the increasing cost of labour, and this is one factor which has given them reason to increase their prices. However, whilst earnings may be increasing in nominal terms, the data suggests they are not keeping pace with inflation and therefore ‘real’ wages (i.e. after taking account of inflation) have fallen in the last year.

Taking a longer-term view, one of the key features of the NI labour market over the last 20+ years has been the low level of ‘real’ wage growth (Chart 5). This is more apparent for those in full-time roles and in particular the public sector where real wage growth has been just 3% since 2000. Private sector full-time workers have fared better with a real increase of 16%.

Part-time workers have seen their wages increase by significantly more in real terms which has been driven in part by the introduction of the National Living Wage. Typically, part-time roles are paid a lower hourly rate than full-time roles and therefore an increase in the legal minimum hourly rate above or level with inflation since its introduction has ensured ‘real’ wage increases for the lowest earners.

It is against this longer-term backdrop, alongside the limited prospect of ‘real’ increases in salaries in the medium term looking forward, that has created an environment of increased industrial unrest, particularly in the public sector. Solutions are hard to identify, people reasonably want their wages to keep pace with the rising cost of living but the Government’s ability to offer increased salaries is very limited given the state of the public finances.



Sectoral forecasts

Manufacturing

The key challenge facing the manufacturing sector in the current climate is rising costs and in particular energy costs. Whilst this is an issue for all businesses, the manufacturing sector is more energy intensive and therefore more vulnerable to the increases currently being experienced. Input/ raw material cost increases are also an issue, partly driven by higher transport costs with long distance supply chains.

Some manufacturers are taking steps to mitigate these cost increases by reducing the number of production shifts and product lines, however this ultimately impacts consumer choice and convenience.

The outlook for the sector remains positive but lead times during the pandemic had become elongated and are now being reduced. Therefore, the shortening of the order book may be masking a reduction in demand.

Construction

The construction sector has also been significantly impacted by cost increases, firstly in terms of energy which has been exacerbated by the loss of the Red Diesel rebate in April 2022. Secondly in terms of building materials which has been driven higher by several factors, initially COVID related supply constraints, followed by COVID catch-up demand globally and then rising energy costs increasing the cost of manufacturing building materials products. This cost of materials issue is taking much longer to normalise than expected.

In terms of outlook, there are concerns of a slow down in the short-term. In previous recessions, firms would have been very focused on winning the next contract, however, given the increased uncertainty around costs and the risks associated with longer-term contracts, construction companies are more likely to walk away from contract awards or not bid. This is a significant change in response.

Private sector services

Private sector services is the largest and most diverse part of the economy and therefore business conditions vary significantly. The hospitality sector is amongst the most impacted by energy price increases and the rising cost of food. Along with the retail (in particular non-food) and leisure sectors, they are at greater risk from falling discretionary income. Retail and hospitality businesses based in larger urban centres are also still experiencing lower levels of footfall as many office workers continue to work from home for at least some of the working week.

Initial observations would suggest that other sub-sectors such as professional services and ICT have been less impacted because they are lower energy intensive businesses and demand for their services has been maintained. It is more likely that the key challenge faced by businesses in these sectors are related to access to talent.

Public sector services

Public sector employment is determined by levels of public sector spending. The public finances were already under significant pressure paying for pandemic related supports, but this has been further exacerbated by the need to fund energy price supports and deteriorating economic conditions which will impact government tax revenues. To fill this fiscal deficit the government announced both tax increases and spending cuts in its Autumn Statement.

Although, the most significant elements of government spending restraints are not scheduled in the short-term, they fall within the forecast period of this outlook. Although medium to longer term policy is difficult to forecast, it is likely that increases in public spending will focus on health and social care in particular.

Sectoral employment actual and forecast (000's)

Industry:	2019-2021	2022-2030	2022-2030
		(baseline)	(upper)
Agriculture	-4.6	0.5	0.7
Mining & quarrying	0.0	-0.1	0.0
Manufacturing	-4.6	4.2	7.0
Utilities	0.2	0.1	0.3
Water supply & waste	0	0.4	0.5
Construction	-5.9	5.7	7.1
Retail	-12.3	-1.5	0.5
Transport & storage	-1.8	3.2	4.2
Hospitality	-3.2	3.6	4.9
ICT	-0.9	7.5	10.4
Financial services	-0.5	1.6	2.8
Real estate	0.3	0.3	1.6
Professional & scientific	1.4	8.3	10.1
Administration services	-5.3	1.6	2.9
Public admin' & defence	0.6	0.7	2.7
Education	4.5	0.8	2.6
Health & social work	4.8	9.3	12.3
Arts & entertainment	-0.9	1.9	1.9
Other services	-7.2	3.9	3.9
TOTAL	-35.9	49.4	76.6

About UUEPC

UUEPC is an independent economic research centre focused on producing evidence-based research to inform policy development and implementation. It engages with all organisations that have an interest in enhancing the Northern Ireland economy. The UUEPC's work is relevant to Government, business and the wider public with the aim of engaging those who may previously have been disengaged from economic debate.

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