Economic Policy Centre Outlook

Winter 2016

The potential impact of Brexit

The immediate impact of the EU referendum has not been as significant as many forecasters anticipated. The economic data released since June has been relatively favourable and whilst many of the projections were wide of the mark, the devaluation of Sterling and the upward pressure on inflation have been some of the few accurate forecasts.

In the wake of both the EU referendum and the US election results, economic forecasts should be more appropriately described as scenario planning. Brexit is a unique event with little solid evidence on which to base a forecast combined with significant uncertainty around the policies President-elect Trump will implement. Therefore, this outlook edition considers a wider range of economic scenarios than usual to analyse the potential economic outcomes.

The Northern Ireland labour market data thus far is relatively positive for 2016, suggesting growth close to overall UK economic performance. Looking forward, a relatively marked slowdown in economic activity in 2017 is projected followed by an increase in growth towards the end of the decade as greater certainty emerges.

Key Forecasts

Northern Ireland

	2016	2017	2018	2019	2020
GVA(1) growth rate	1.9%	0.9%	1.1%	1.5%	1.5%
Unemployment rate(2)	3.1%	2.9%	2.9%	3.0%	3.0%
Employment growth rate	2.0%	0.9%	0.4%	-0.2%	0.3%
House price growth rate	4.8%	4.7%	2.4%	6.2%	4.2%

United Kingdom

	2016	2017	2018	2019	2020
GVA(1) growth rate	2.1%	1.4%	1.6%	2.0%	1.9%
Unemployment rate(2)	1.4%	1.4%	1.6%	1.7%	1.6%
Interest Rates(3)	0.4%	1.0%	2.0%	3.0%	3.0%
Inflation(4)	0.8%	3.2%	3.2%	4.0%	4.0%
House price growth rate	5.5%	5.0%	4.0%	6.0%	3.9%
Weighted Trade Index(5)	2.6%	2.8%	3.4%	-4.0%	4.4%

Source: CBR-UUEPC

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: Claimant count rate as a % of 16 – 64 population. GB claimant count rate impacted by transition to Universal Credit
Note 3: Bank of England base rates
Note 4: UK Consumer Prices Index (CPI)
Note 5: Weighted trade index sourced to Oxford Economics, Brexit adjustment UUEPC

In this edition

- **The potential impact of Brexit –** in addition to lower economic growth in 2017, a modest fall-back in the labour market is anticipated. This is in stark contrast to the strong employment growth enjoyed by the local economy since 2012. This edition outlines the economic implications associated with a range of post-referendum scenarios.

- **Migration –** control of immigration appears to be a key priority for the UK Government in its Brexit negotiations. This could have significant implications for the labour market both in terms of accessing skills and putting upward pressure on earnings. The impact of lower migration across industry sectors in the NI economy is discussed.

- **Focus on consumers –** both the UK and NI economies are very heavily reliant on consumer spending. Therefore, if recent consumer spending trends are maintained, overall economic growth will continue and a recession would be unlikely. However, that is not a certainty and the factors driving consumer behaviour are considered.

- **Areas of policy focus –** the breadth of the negotiations between the UK and the EU will be significant and given NI's relative size, the Executive's ability to change the policy approach in many areas will be limited. Therefore, it is important the Executive focuses on those key areas of specific interest to Northern Ireland where UK Government policy can be influenced.

The potential impact of Brexit

The UUEPC economic forecasts are identified using an econometric model[1] developed in partnership with the Centre for Business Research based in the University of Cambridge, Judge Business School. As with all economic modelling, the forecasts produced are sensitive to the assumptions applied, however, following the EU referendum the assumptions, or 'judgement calls', forecasters must make have increased significantly giving a much greater range of likely outcomes.

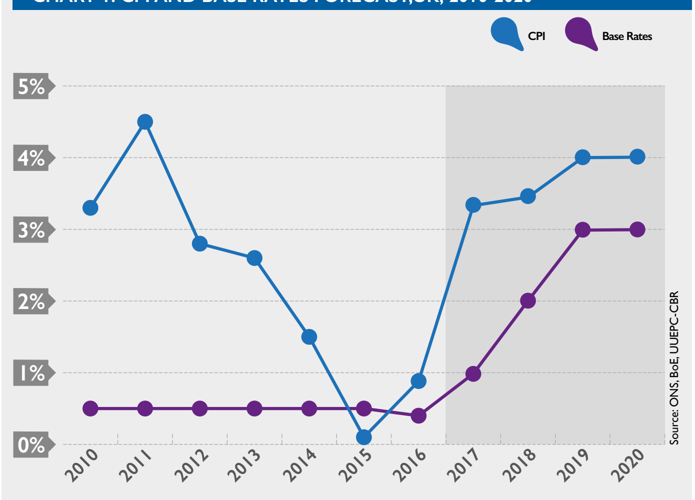
Therefore, this edition of the economic outlook considers a range of economic scenarios (optimistic, central and pessimistic). Whilst a slowdown is anticipated in 2017, followed by a moderate upturn in the period 2018 to 2020, the UK's susceptibility to a consumer slowdown will bring growth rates back to lower levels in the longer term. Although productivity is anticipated to continue at its recent level of limited growth, this feature will support an improving labour market.

This year the Northern Ireland economy is performing well against the UK. The latest labour market data indicates the local labour market is out-performing the UK average growth this year. NI employment has increased by 3.3% compared to just 1.3% across the UK as a whole between Q3 2015 and Q3 2016 (source: LFS).

Interest rates lower for longer

The UUEPC forecasts UK inflation increasing to approximately 4% by 2020, driven primarily by the depreciation in Sterling. This is well above the Bank of England target rate of 2% and the OBR forecast range of 2%-2.5%. In mid-October, the Governor of the Bank of England, Mark Carney, stated "We're willing to tolerate an overshoot in inflation over the course of the next few years in order to avoid [higher joblessness]." Whilst it is not clear how far above the target rate of 2% the Bank of England would tolerate or for how long, it is reasonable to conclude that the pace of interest rate increases will be slower than previously anticipated.

CHART 1: CPI AND BASE RATES FORECAST,UK, 2010-2020



[1] www.cbr.cam.ac.uk/fileadmin/user_upload/centre-for-business-research/downloads/working-papers/wp472.pdf

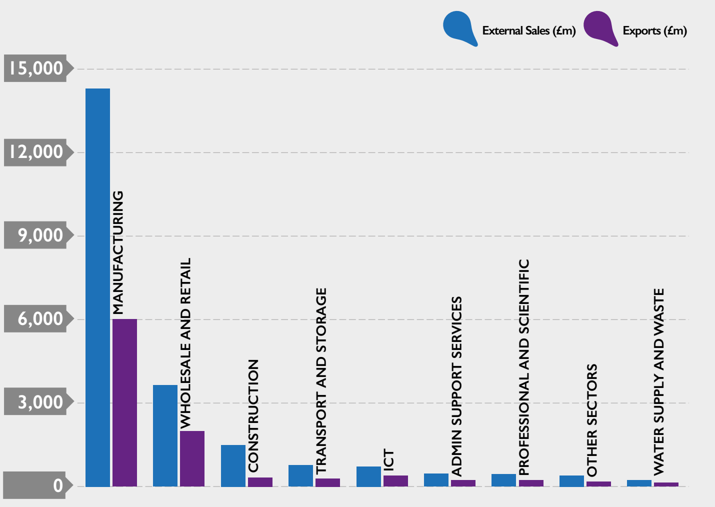
The slide in Sterling and changing trade picture

Although the timing of the pound's depreciation on the foreign exchange markets can be directly linked to the EU referendum result, the scale of the slide is a function of the UK's gaping current account deficit. The deficit currently sits at 5.9% of GDP (Q2 2016) compared to just 0.2% as recently as Q2 2011. This is unsustainable and pointed to an over-valued currency supported by strong consumer spending and a global investment market encouraged by steady headline growth in the UK. As a consequence, the devaluation is the necessary adjustment to help address the current account deficit and the referendum result was merely the catalyst.

Whilst tariffs and other trade barriers would result in lower levels of international trade, a factor reflected in UUEPC forecast assumptions, the depreciation in Sterling should help stimulate UK exports. Furthermore, if trade tariffs are introduced (and that is not the desired outcome) they will also impact imports and should create some opportunities for import substitution.

Growing exports has been a central tenet of recent Northern Ireland economic strategies and they have risen strongly in recent years, goods exports increased by 9.5% in the 12 months to June 2016 (source: HMRC, Regional Trade Statistics). Whilst this is positive, two policy issues arise, firstly the number of exporters is falling (down 4.5% in the last year) and secondly, it is important to understand the extent to which Single Market access is a critical factor in the performance of NI exporters. Chart 2 below shows a breakdown of all NI exports and external sales in 2014.

CHART 2: NI EXPORTS AND EXTERNAL SALES BY SECTOR, 2014



Note: Exports - sales outside the UK. External sales - sales outside NI

Source: Dept for the Economy

The impact of reduced Foreign Direct Investment (FDI)

FDI is also likely to be impacted by the Brexit process. Indigenous business investment will most likely be delayed due to uncertainty rather than cancelled, thus having a greater impact on the profile of investment spending rather than the total amount. This is in contrast to the impact on FDI which could see a permanent reduction for the two to three years when uncertainty is at its height, before a return to normal levels.

The future of FDI is also complicated by the US election result. Whilst the Trump administration has yet to set out its detailed economic policies, a significant reduction in business taxes along with other measures to encourage domestic investment in the US has the potential to impact inward investment flows to NI.

Inward investment is an important element of our economic strategy, with foreign-owned businesses (i.e. non-UK) creating approximately 20,000 employee jobs between 2009 and 2015 (source: ONS Inter-Departmental Business Register, DfE). Therefore a short-term reduction in inward investment would contribute to an economic slowdown, but a much bigger issue would arise if inward investment was reduced over a long term period due to an unfavourable outcome from the Brexit negotiations.

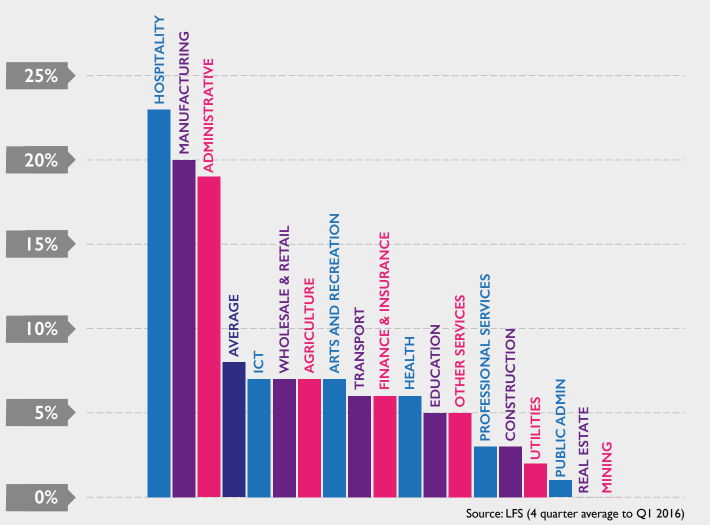
Importantly, this more pessimistic longer term outcome is unlikely and should not undermine the attractiveness of Northern Ireland in terms of skills, location, language, time-zone and cost to overseas investors.

Migration

Controlling migration appears to be a central priority of the UK Government's Brexit negotiating strategy, but a replacement immigration policy has yet to be developed.

In NI the employment rate for non-nationals, at 81%, is significantly higher than the employment rate for nationals (i.e. British or Irish), at 67%. Overall, non-nationals make up 8% of the workforce in Northern Ireland, but at a sectoral level it is more varied, with the hospitality and manufacturing sectors employing 23% and 20% non-nationals respectively (see Chart 3).

CHART 3: % OF SECTORAL WORKFORCE FROM OUTSIDE THE UK AND ROI, 2015-16 (4QTR AVERAGE)



Source: LFS (4 quarter average to Q1 2016)

Reducing inward migration raises a number of economic issues. Access to a large external source of labour has kept earnings low, therefore a reduction in inward migration could result in upward pressure on salaries. This is a benefit to employees but represents a cost to business and the response from the business community will determine the economic impact. Some sectors such as retail, hospitality and the care industry are delivered locally and cannot be off-shored, but an increase in the cost base and reduced access to skills in other sectors, such as manufacturing, could result in some production being moved to other jurisdictions.

Typically, as wages are pushed up, economies transfer lower skilled jobs to developing nations and then transition into higher value added sectors. However, the ability of individuals in lower skilled jobs to make the same transition to high value added employment is less clear and has been cited as a contributing factor to the US election result.

The NI Skills Barometer, developed by the UUEPC, highlighted that significant skills shortages exist in key areas and, in the absence of a change to the skills mix emerging from NI education institutions, it is unlikely Northern Ireland would achieve its economic ambitions without the inward migration of skills.

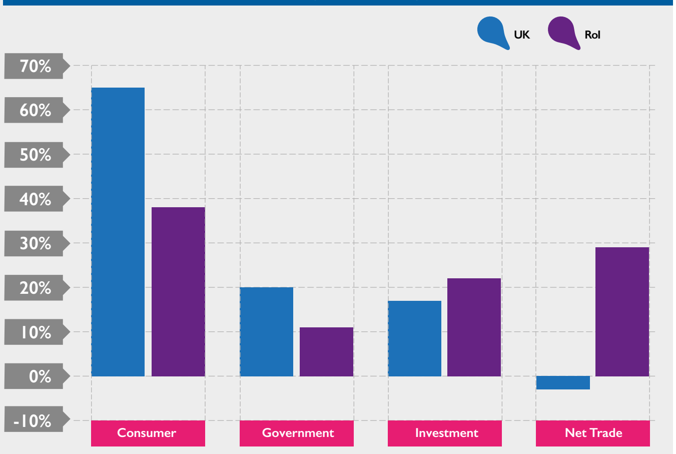
The focus on consumers

Consumer spending is critical to the performance of both the local and UK economies, equivalent to 65% of GDP in the UK, compared to 38% in Republic of Ireland (see Chart 4). However, consumer spending is dependent on income which, in turn, is dependent on the performance of businesses and Government spending. Therefore, consumer spending is considered, in economic parlance, as a consequence of conditions elsewhere in the economy and not the initial driver of economic activity.

A further determinant of consumer spending is the savings ratio which itself is influenced by a number of other factors, including confidence around job security, house prices, the rate of return from savings and investment and inflation expectations.

Consumer spending levels have been maintained since the referendum in June and this has contributed to the relatively strong economic performance thus far. The UUEPC central forecast assumes that this will continue, albeit at a slower pace, but an economic shock impacting any of the factors identified above and resulting in a retrenchment in consumer spending, represents the primary risk to the short-term economic growth forecasts. In the longer term, the more fundamental risks are inflation and as a consequence interest rates and stagnation in real earnings growth.

CHART 4: COMPONENTS OF GDP, UK VS. ROI, 2015



Source: ONS (UK) & CSO (Ireland)

Areas of policy focus

Given the uncertainy created by the referendum result, there is now pressure on the Executive to find the appropriate policy response. To that end, a bespoke unit has been established within the Executive Office to consider and coordinate the preparations for Brexit.

There are a wide range of economic issues to consider including the potential implementation of trade barriers and tariffs, but it should be recognised that these issues impact the UK as a whole and the NI influence would be limited. The Executive would therefore be advised to focus on the areas of the negotiation which are more specific to Northern Ireland.

Dealing with the border

The land border is a very specific NI issue which the Executive has already highlighted to the UK Government. Finding policy solutions to cross-border trade and visitor travel as well as those living and working on different sides of the border must be a priority. Understanding how the Common Travel Area will work, the need (or otherwise) for travel visas and how potential customs arrangements would operate should be an area of focus.

People and businesses tend to adapt quickly to change, but only when the steps which need to be taken are set out clearly. The uncertainty surrounding these issues could be a greater problem than implementing the solution – when it is known.

Legacy EU funding programmes

The UK Treasury has given funding guarantees across a range of EU programmes out to 2020 and it is likely that at least some of the funding programmes will continue in a similar manner into the medium term. However, in the longer term, the potential exists for the UK Government to re-prioritise the allocation of the funding currently sent to Brussels. The devolved administrations may seek to have their current EU allocations continue but direct from Treasury rather than through Brussels.

This would provide the NI Executive with an opportunity to develop programmes that more closely meet local requirements rather than tailor activities to meet broader EU objectives. Given Northern Ireland's lacklustre economic performance, at least in GDP/ GVA terms, relative to the UK and the Republic of Ireland over recent decades, a greater focus on economic priorities should be considered by the Executive.

Not being distracted by Brexit

The most important policy advice to the Executive at this point would be to focus on the key economic challenges facing the local economy and not to be too distracted by Brexit. Northern Ireland's structural weaknesses in areas such as productivity, non-student economic inactivity and the proportion of school leavers with low or no qualifications have persisted for many years. As a result, many of the key outcomes in the Programme for Government, such as 'more people working in better jobs' and 'prospering through a strong, competitive, regionally balanced economy' remain relevant inside or outside the EU.

Scenario analysis

This edition of the economic outlook considers a range of economic scenarios (optimistic, central and pessimistic) to identify potential economic outcomes over the next few years. These scenarios are based on assumptions which UUEPC consider to be reasonable on the evolution of the Brexit process. Others may take a different view on the assumptions applied.

Greater outcome uncertainty

The range of possible economic outcomes is much wider today than at any time since the global financial crisis. This is highlighted in the UUEPC 10 year employment projections, where the central scenario forecasts the creation of 32,500 net new jobs by 2026. However a pessimistic scenario, although unlikely, could result in net job losses of 4,500 over the next 10 years from current levels. In contrast, a more optimistic scenario (also unlikely and based on convergence with UK employment rates) could result in up to 87,000 net new jobs being created over the same time period. This range of projections indicates the current level of economic uncertainty.

This analysis has outlined the impact of Brexit in employment terms, in contrast to most economic analyses undertaken to date which has focused on GDP. On that basis, the difference between our pessimistic and optimistic scenarios is equivalent to approximately 11% of GDP by 2026.

The US election result adds to the level of uncertainty being faced by policy makers and the business community. This is based on President-elect Trump's implied economic policy direction of increased protectionism and lower corporate taxes encouraging the repatriation of US corporate profits. However, other economic policy comments would suggest that the UK would be 'front of the queue' for negotiating a new trade deal. These contradictory statements, both positive and negative, make it more difficult to make longer term forecasts.

Box 1:

Central estimate – key assumptions

These assumptions are applied at the UK level, which in turn determines the level of Northern Ireland growth. The central estimate scenario is based on the following assumptions:

- Migration – long term net migration capped at 185,000 p.a.
- Business investment – reduced by 7% per annum from 2017-20
- Foreign Direct Investment – reduced by 30% 2018-20
- Consumer spending – no direct impact
- Weighted trade index – 4% fall in 2019-20, but slow increase thereafter
- Imports – 5% fall in 2019-20, but slow increase thereafter
- Government spending – as per OBR.

Assumptions applied are critical

The central estimate assumptions (see Box 1) are quite severe both in the short and long-term. For example, a significant reduction in exports to the EU market is assumed but gains in non-EU markets are slow to materialise. In addition, only a small reduction to imports is assumed and may be substituted by imports from non-EU sources. The uncertainty surrounding future trading relationships will result in lower business investment in 2017 and 2018, but this should be temporary with a bounce-back in 2019 as greater certainty emerges. Foreign Direct Investment will also be significantly impacted in 2017 and 2018.

Worse-case scenario

Although the central estimate already includes quite significant reductions, a worse-case scenario is also explored. Its outcomes are based on the lower range estimates identified by independent forecasters and would include an even greater reduction in trade levels and business investment leading to a deterioration in consumer confidence and an associated fall in consumer spending. It must be stressed that this is considered a highly unlikely outcome but cannot be discounted. The data thus far indicates that consumer spending has held up, however in the longer term, rising inflation and eventually the need to increase interest rates could impact consumer spending and business investment levels.

Table 1: Sectoral employment 2016-26 across scenarios

Industry:	Worse case (Pessimistic)	Central estimate (Expected)	UK convergence (Optimistic)
Agriculture	-3,400	-600	400
Mining & quarrying	0	0	0
Manufacturing	-5,900	2,600	5,000
Utilities	0	0	200
Water supply & waste	0	0	200
Construction	2,800	4,100	7,300
Retail	-1,300	0	1,200
Transportation	900	2,100	3,300
Accommodation	1,200	3,700	7,800
ICT	900	3,800	11,100
Financial services	-1,500	-400	4,000
Real estate	0	800	1,200
Professional & scientific	1,000	6,700	19,300
Administration services	1,200	6,900	9,900
Public Admin	-3,900	-3,900	-700
Education	-1,400	-1,400	0
Health	3,400	3,900	9,800
Arts & entertainment	1,200	2,500	4,300
Other services	300	1,600	2,700
Employed by Households	0	0	0
TOTAL	**-4,500**	**32,500**	**87,000**

Note: Totals may not sum due to rounding.

Outlining the research agenda

The UUEPC research agenda is focused on the strategic economic priorities of the Northern Ireland economy and in consultation with our sponsors, the Centre is taking forward the following projects:

- **UUEPC UK and Northern Ireland macro-economic model** – the team are continuing to develop the macro-economic forecasting model in partnership with the Judge Business School, University of Cambridge. The model provides the framework and empirical test bed to measure the impact of a wide range of policy options as well as underpinning the economic forecasts presented in this report.
- **UUEPC Local Government economic model** – following the devolution of many economic development powers to local government, the UUEPC is enhancing its Northern Ireland economic model to provide local government forecasts. This should assist the new councils to identify appropriate economic development policies for their individual areas.
- **The economic impact of the National Living Wage** – this research examines the potential economic impact from the introduction of the National Living Wage in Northern Ireland. Given lower average salaries in the local economy, the impact will be greater than elsewhere in the UK. This is good news for some employees but the additional cost burden on business could also have a negative impact.
- **Corporation Tax modelling** – the Centre continues to work with the Department for the Economy and Department of Finance on a number of policy areas linked to the devolution of Corporation Tax including the revised economic impact and the potential reduction to the Block Grant.
- **Further development of the Northern Ireland Skills Barometer** – the Centre is now working with the Department for the Economy to update the Skills Barometer to reflect the latest economic conditions and identify the need for upskilling the existing workforce.
- **Economic inactivity in Northern Ireland** – this detailed study analysed the latest trends in economic inactivity and drivers of change. The study finds that it is not possible to raise the employment rate and close the gap with the UK without reducing economic inactivity, which is included as an outcome in the new Programme for Government.

New sponsors

UUEPC is pleased to have signed new sponsorship agreements with Catalyst Inc (formerly the Northern Ireland Science Park) and Fermanagh & Omagh District Council. We look forward to having a mutually beneficial research relationship with this new sponsor group.

About Ulster University's Economic Policy Centre

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 Centre'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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