Outlook: Winter 2013

Northern Ireland
Centre for Economic Policy

First Steps to recovery

There is little doubt that economic recovery is underway in Northern Ireland. A range of supportive economic indicators including the most recent quarterly jobs data, unemployment figures, the Purchasing Managers Index (PMI) and consumer confidence surveys all suggest growth. But how strong is this recovery and will it be sustained? There have been false dawns before and five years since the start of the financial crisis, it would be prudent to consider the factors driving the recovery and examine the steps needed to increase its pace and assist its sustainability.

The preliminary forecast from the NICEP Northern Ireland model suggests modest growth of 0.7% in 2013 and 1.5% in 2014. This equates to approximately 6,000 net new jobs in 2013 and a further 12,000 in 2014. In the longer term, the headwinds that on-going austerity, which is set to increase in the early years of the next Parliament, rising interest rates and increasing inflation will constrain economic growth.

The weight of the recovery lies almost exclusively with the private sector and whilst growth in business investment and consumer spending should accelerate, this will be at a rate insufficient to achieve Northern Ireland's economic ambitions.

Nurturing recovery but recognising risks

It is recognised that this projection of a recovery failing to gather pace over the medium term is at odds with most published forecasts, and this is discussed in greater detail later in this report.

But we also acknowledge that an important balance must be struck at this time. Confidence plays a critical part in the spending plans of both consumers and businesses and any 'talking down' of recovery is most unhelpful. However, now is not the time for self-congratulations from the policy making community. It is time to listen to the challenges facing businesses and consumers and help design a policy environment that will allow the recovery to flourish and meet the challenge of on-going fiscal tightening.

Key forecasts

United Kingdom

	2013	2014	2015	2016-20[1]
GVA	1.4%	1.8%	1.9%	1.7%
Employment	1.0%	1.3%	1.0%	0.1%
Unemployment rate[2]	3.6%	3.5%	3.4%	3.5%
House prices (£)	£224,000	£230,000	£249,000	£329,000
Base rates	0.5%	0.5%	0.5%	3.6%
Inflation	1.3%	1.6%	2.4%	4.2%
World trade	2.8%	5.8%	7.4%	6.5%

Northern Ireland

	2013	2014	2015	2016-20[1]
GVA	0.7%	1.5%	1.5%	1.3%
Employment	0.7%	1.4%	1.1%	0.2%
Unemployment rate[2]	5.5%	5.5%	5.0%	4.2%
House prices (£)	£132,000	£139,000	£155,000	£221,000

Note 1 – Average rate over the 5 year period
Note 2 – Claimant count as a % of 16-64 population

Sectoral outlook

Industry

The manufacturing sector has posted positive jobs growth in the first half of 2013 (although an unusually high self-employment estimate in Q2 2013 is likely to be revised down). Notable expansions in existing firms, particularly in the food processing sector, and improving demand from trading partners is helping drive growth. The sector is forecast to contribute just over 40% of total GVA growth over the next 5 years, underscoring its continued importance to the Northern Ireland economy (employment contribution is more modest at 12%).

Construction

Having dipped below 50,000 workers for the first time since 1997, the construction sector in 2013 is beginning to see very modest growth. House building has begun to tick upwards, and with significant pent up demand, given the lack of building in the last 5 years, this should continue. At 6% of total employment the sector is now below the long term average (it would currently have around 8,000 more jobs if it were to return to long term average levels of 7%) and this suggests the long period of contraction in the sector is at an end.

Private services

Private services have been growing strongly in the UK but relatively poorly in NI. In total, the sector has 23,000 (-5.7%) less jobs in NI than in 2008, compared to 2.3% more in the UK as a whole. This is partly explained by the scale of problems in the housing market in Northern Ireland but nevertheless performance has been disappointing. Notable inward investments in the finance, ICT and professional services sectors should begin to drive growth across the sector and the prospects are relatively strong.

Public services

Looking at public sector services (public administration, health and education) there is little evidence of pronounced austerity in the headline employment numbers. Job levels are broadly unchanged since 2008 across the three sectors. Public administration is down approximately 5,000 jobs but employment in health is up by a similar amount. The strong demand evident in health will drive growth in this area (whether it is provided publicly or privately) but with only 8,000 jobs forecast across the three sectors by 2018 the challenge for job growth elsewhere in the economy is evident.

Sectoral employment forecasts ('000s)

Industry	01-07	07 - 13	13-19
Agriculture	-4	4	2
Mining and quarrying	1	-1	0
Manufacturing	-15	-8	4
Utilities	0	0	0
Water supply & waste	1	0	1
Construction	14	-31	2
Retail	18	-7	1
Transportation	2	-2	2
Accommodation	5	-1	1
Information & Comm's	2	2	2
Financial activities	2	0	1
Real estate	4	1	1
Professional & scientific	8	-2	2
Administration services	16	1	5
Public Admin' & defence	-2	-6	0
Education	6	-2	2
Health & social work	17	7	6
Arts and entertainment	3	1	1
Other services	2	0	1
Employed by households	-1	0	0
Total	**79**	**-44**	**33**

Headline sectoral GVA forecasts (% p.a.)

	2013	2014	2015	2016-20
Production	0.0%	0.1%	0.5%	0.4%
Manufacturing	5.8%	4.3%	3.4%	3.1%
Retail, hotels and leisure	-1.3%	0.2%	0.8%	0.6%
Professional and adminstrative	0.3%	2.1%	2.1%	1.9%
Public services	0.0%	0.8%	0.7%	0.5%
Total	**0.7%**	**1.5%**	**1.5%**	**1.3%**

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Outlining the research agenda

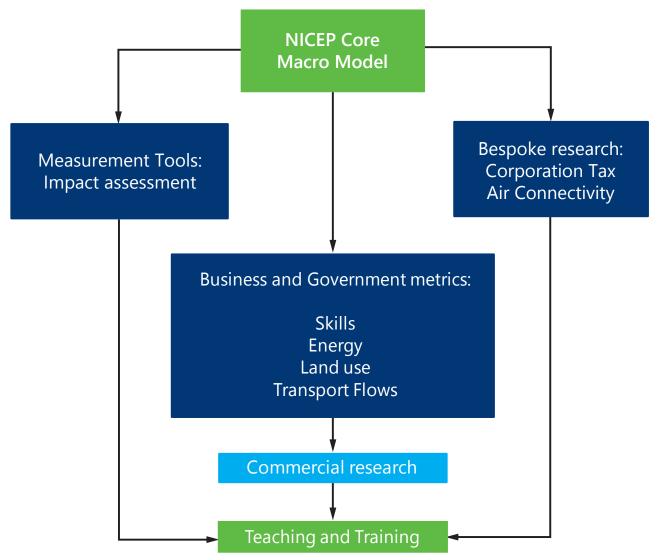
NICEP exists as a research centre to 'help Northern Ireland achieve its economic ambitions' and therefore it is important that its research agenda is focused on the strategic economic priorities of the Northern Ireland economy. In developing a suitable research agenda, it is essential to listen to Government, business and consumer needs. However it is also important to ask the questions which may not be obvious in the pressured environment of operational deadlines and immediate political imperatives.

It is against this backdrop, and as indicated previously in this edition, that the NICEP Core Model is being developed to provide the framework and empirical test bed, to explore policy options and measure impacts. These will align with on-going Government research activities including the development of Input Output tables for Northern Ireland. Be-spoke research will also be carried out which is relevant to the NICEP sponsor group as well as the wider Northern Ireland economy. For example a set of business metrics will be identified for the sectoral forecasts, including skills requirements, energy needs, land use and transport flows.

In addition, a strand of strategically relevant commercial consultancy will complete the research agenda.

Finally, all strands of NICEP research will feed into the teaching of Economics students in the Ulster Business School. Thus helping to educate and develop the next generation of economic policy makers.

The NICEP research agenda



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About NICEP

NICEP 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 general public with the aim of engaging those who may previously have been disengaged from economic debate. In addition, staff from the Centre equip students with practical skills required in the workplace, which complements the existing provision of economics teaching at the University of Ulster.

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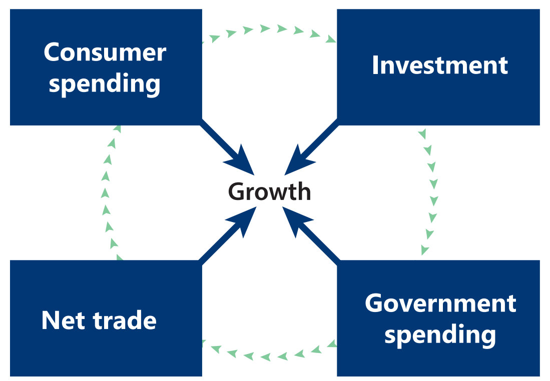
In this Edition

- **Understanding growth:** Economics can be made unnecessarily complex, whilst in reality the drivers of economic growth are relatively straightforward. In this edition we unpick 'growth' into its constituent parts.
- **Aligning polices to business needs:** With the private sector expected to lead the economic recovery, we look at the issues businesses are consistently raising and explore the extent to which policy could align more closely with those priorities. Linked to this, we also explain NICEP's approach to determining its research agenda.
- **The macro forecast and sectoral outlook:** Economic growth across the UK is anticipated to accelerate in 2014, but with increasing fiscal constraints, rising interest rates and inflation, growth is forecast to be constrained in the medium term. This edition discusses the contrast between NICEPs forecast and the current consensus view.
- **Looking long:** There is little clarity over Northern Ireland's long term economic aspirations. In this edition we assess the long term forecasts for Northern Ireland.

Understanding growth

There is a general familiarity with the terms Gross Domestic Product (GDP) and Gross Value Added (GVA). However, it is not obvious that these concepts are fully understood. In essence, GDP and GVA measures the value of output produced by an economy and these measures are used as proxies for economic wealth. GDP/ GVA is the aggregate expenditure of 4 broad groups in the economy[1], set out below:

The components of growth



Therefore a forecast for GDP/ GVA, is an aggregate of the forecasts of these four distinct components. Looking at an analysis from this perspective allows us to identify the key drivers of economic recovery. Put simply economic growth cannot occur without at least one of these four components growing.

It is widely recognised that economic forecasters have not performed well in recent years. They did not see the recession coming, and they have thus far consistently over-predicted the recovery. This is in part explained by the approach adopted in many economic models including the Government's OBR (Office of Budget Responsibility) model. These existing models rely on concepts such as 'trend rates of growth' and an inbuilt assumption that market corrections and monetary policy will revert the economy to its long-run growth path[2]. The only question outstanding therefore was, how quickly would this occur? The consensus view was that economic recovery would be led by a rapid increase in business investment (as the large corporate sector had significant levels of cash holdings). Clearly this has not happened yet, primarily because firms were uncertain of their domestic and export customers' likelihood to spend and thus were reluctant to invest. Therefore in order to develop a more accurate forecast of economic growth, it is important to explore the factors driving the behaviour of each of the four components.

Developing the NICEP Core Model

A full '4 sector' forecast model has not yet been fully developed at a regional level (i.e. for NI), largely because the required data is not yet collated. A major component of the NICEP research agenda is to build a model in this structure, but this requires the capture and creation of data for consumer spending, government spending, trade and investment. Development of this model will occur over the next 12 months and will allow NICEP to conduct a wide range of scenario analysis to support policy debates in a more evidenced and quantified way than is currently possible. Examples of this could include assessing the impact of changes in policy areas such as Corporation Tax and export performance.

The NICEP Core Model will be built using the new UK modelling framework being developed in the Judge Business School, Cambridge by Graham Gudgin and Ken Coutts with support from Prof. Neil Gibson of NICEP. This model is not subject to artificial constraints such as 'trend growth' and also considers the financial sector as a separate component within the economy. It is a purely demand driven 'Keynesian' model based on econometric equations developed using economic data from the last 60 years. A key requirement of the model is that it would have accurately forecast the 2008 - 2013 economic recession, conditional on knowing the paths of world trade and mortgage lending to households. The provisional results from the model suggest it is capable of making such a conditional forecast. Further information will be made available over the next twelve months to stimulate discussion within the economics community as part of the development process.
This report presents the components of growth forecast for the UK, but subsequent reports will also contain this component analysis for Northern Ireland.

[1] *The difference between GDP and GVA is in indirect taxes and subsidies, most notably VAT*

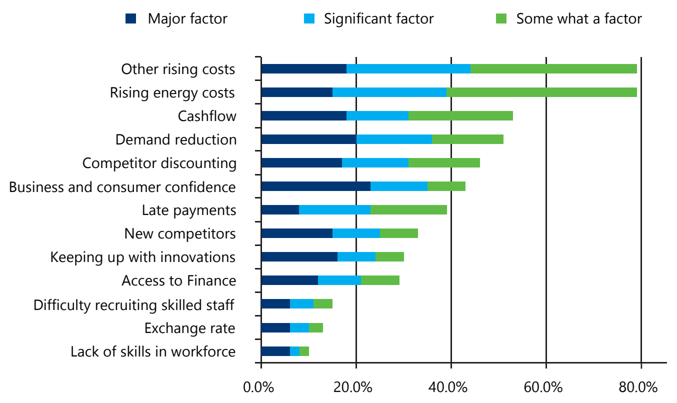
[2] *In the case of the OBR, there has necessarily been an assumption that a large part of the UK economic capacity has been 'lost' since 2007.*

Aligning policy to business

After five years of very challenging economic conditions, the policy landscape in Northern Ireland remains largely unchanged. There have been a number of new initiatives, such as the Invest NI Jobs Fund and welfare reform (being introduced nationally). However, in general, new policies have been few and far between. Devolution of Corporation Tax remains unresolved and, for reasons which are not entirely clear, awaits the outcome of the Scottish referendum. This is an issue which could and should have been resolved before now.

In identifying relevant issues for research, it is important to focus on the areas businesses highlight as their key challenge. There has been significant attention focused on 'access to finance' as a key inhibitor of growth. However, the business community do not identify this as their number one concern. The latest IntertradeIreland (ITI) quarterly business monitor survey for Q2 2013 identified the main issue impacting business as rising costs. The ITI survey has identified this as the number one issue for business in each of the last 5 quarters. Perhaps there may be merit in prioritising this area for further research.

Key issues facing business



Source: IntertradeIreland and Perceptive Insight

Another potential area for review could focus on the effectiveness of Government's current approaches to the redistribution of corporate income. We tax some firms, through business rates, and offer support to others through industrial de-rating, capital grants and other incentives. Taken as a whole, it is reasonable to question the fairness and equity of this approach and seek to understand if it is achieving the optimum economic benefit for Northern Ireland.

In another area of economic policy, export performance is a key focus for the NI Executive. Given the importance of exports to the NI economic strategy, it is remarkable that the value of exports from Northern Ireland is not measured. This seems an obvious gap in the evidence base and one which should be urgently addressed. This is currently a focus for DETI but perhaps the process needs to be prioritised. It is difficult to see how export performance and policy success can be tracked without the relevant outturn data.

These are just a selection of potential research areas identified by NICEP which align with the priorities of business. Moving forward, NICEP will seek to discuss these priorities with the wider economic community and to agree a strategy with our Advisory Board. Future editions of this briefing will focus on aspects of the agreed research agenda.

UK macro forecast

The UK economic outlook forecasts growth in consumer spending and business investment in 2013, which should accelerate in 2014. However, given greater fiscal constraint currently planned in the early years of the next Parliamentary term, coupled with anticipated increases in interest rates, our forecast points to lower growth levels in 2016 and 2017.

This is in contrast to the consensus economic forecast view, in which the strength of the consumer and business recovery is anticipated to be sufficiently strong to offset reductions in government spending. In these forecasts rising interest rates do not sufficiently hamper consumer spending (although this is commonly cited as a key risk). The Government may have some flexibility to pursue a different policy course depending on the strength of the recovery, but it is very difficult to envisage a scenario where interest rates will remain at record low levels into the medium term. Finally it is worth highlighting that the consensus view has forecast an accelerating recovery 'next year' in each of the last 4 years!

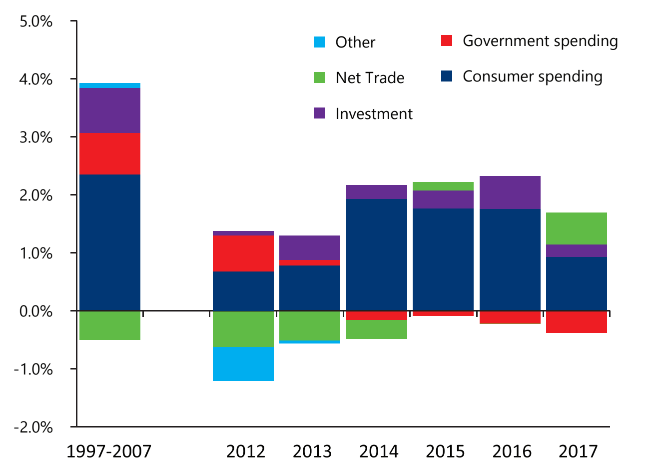
Could the recession have been less painful?

Using the new UK macro model to simulate economic activity in the last five years, it is possible to ask if conditions could have been different. Early model runs suggest that it could and a significant fiscal stimulus (or reflation) policy during the recession could have resulted in lower job losses and faster economic growth at the cost of only marginally higher government debt. A paper exploring this hypothesis will be published later in the year but in simple terms the model results are more supportive of a Keynesian approach, which would be pro stimulus and less supportive of the neo-classical view, which would have expected a sharper market-led recovery that evidently has not yet materialised. More research is required to determine what this means for future policy, but it would appear on the current model projections that future austerity could come too soon and risk economic recovery.

UK macro-economic forecasts

	2013	2014	2015
GDP	1.4%	1.8%	1.9%
Consumer spending	0.8%	1.9%	1.8%
Government spending	0.1%	-0.2%	-0.1%
Investment	0.4%	0.2%	0.3%
Net Trade	-0.5%	-0.3%	0.1%

UK: Contributions to growth



Note: NI macro forecasts to follow in future editions

Looking long

It seems appropriate in the first edition of the NICEP outlook to ask 'what is Northern Ireland's economic ambition?' or more plainly 'where do we want to be?' Although there have been many targets set across a very large number of economic strategies (PwC identified 15 major economic reports between 1957 and 2009), there appears to be little sanction, or even public recognition, if these targets are missed.

In simple terms, most economic ambitions are focused around job creation and income/ productivity growth. Over the recent past one or other of these targets has gained greater focus, but moving forward, both should form an equal part of our aspiration. There are other longer term ambitions that may be relevant in an economic context. For example aspects such as: fairness; equality; sub-regional growth; and environmental impacts are all relevant, but as a starting point 'more jobs higher incomes' is a reasonable place to begin.

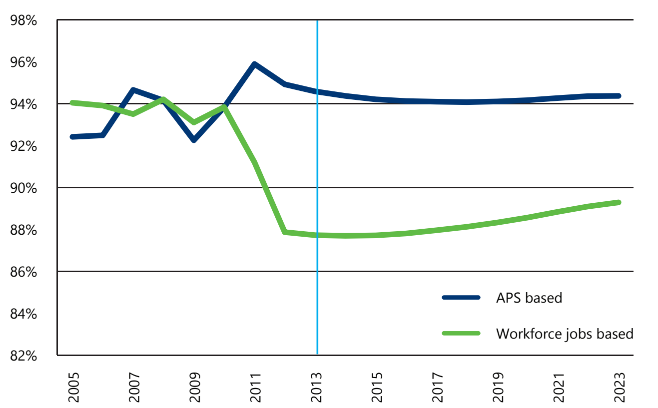
Falling short

The current forecasts from the NICEP model suggest Northern Ireland will fall short of its ambitions with neither employment creation nor income growth showing substantial improvement compared to the UK benchmark[3].

[3] *As an aside, NICEP recognises the need for debate on the appropriateness of the UK benchmark.*

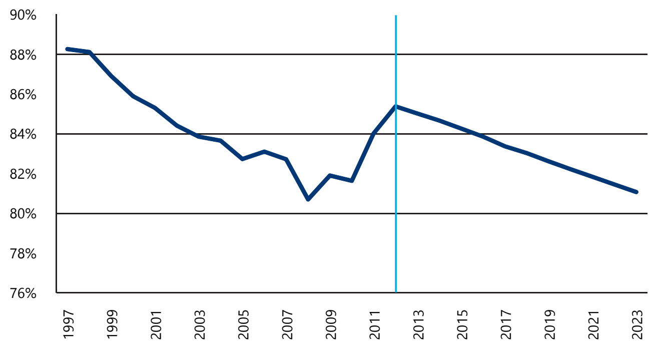
The current the labour market position is difficult to ascertain. The Annual Population Survey suggests there has been an improvement in the relative position of Northern Ireland with the region being only four percentage points behind the UK average. In stark contrast, the Workforce jobs data suggests a gap of twelve percentage points between NI and the UK average. It is essential that further investigation is conducted to understand this anomaly and identify an accurate picture of the Northern Ireland economy.

Relative employment (UK = 100)



Analysing other data sources would imply that the workforce jobs data appears more plausible, although it could overstate the scale of job losses incurred.

Relative productivity (UK = 100)



The latest available GVA data (up to 2011) suggests that Northern Ireland has broadly tracked UK growth rates. Taken together with the employment data, this implies improving relative productivity.
This seemingly strange pattern of Northern Ireland growing but not creating jobs may be partly explained by the following factors:

- Low interest rates helping more firms in the UK (particularly large PLC's who have greater access to capital markets) to recruit or retain labour.

- Loss of lower productivity jobs in Northern Ireland in construction and retailing that had been reducing productivity in the boom years.

The forecasts suggest that relative productivity will begin to fall back as a less favourable sectoral composition of new jobs over the forecasts weakens the relative position.