Ulster University

Economic Policy Centre Outlook
Autumn 2018

Different dynamics - record breaking jobs but challenging times ahead

Local economic indicators are currently showing a very mixed picture. Job creation remains strong, unemployment is at historic lows and business sentiment surveys tend to suggest continued growth in the short term. However, economic inactivity remains relatively high, productivity growth has stalled for almost a decade and there are significant global risks which point to a more challenging economic outlook. The trend towards increased protectionism poses the most immediate threat to global growth, confidence, asset prices and investment.

Nationally, ongoing uncertainty surrounding the future trading relationship with the EU continues to create front page news. Furthermore, the long-term economic challenges locally present challenges to policy makers in Government and senior executives in business.

It is against this backdrop that the UUEPC has developed its Autumn 2018 Outlook. The 'baseline' forecast is for economic growth to continue at modest levels in the short to medium term whilst narrowly avoiding a recession. Growth is then forecast to pick up in the longer term as the global economy moves into a stronger growth phase.

Key Forecasts

	2018	2019	2020	2021	2022
Macroeconomic Variables					
BoE: Interest rate	0.75%	0.75%	1.00%	1.00%	1.00%
CPI: Inflation (% p.a)	2.7%	2.6%	2.0%	1.4%	0.7%
World trade (% p.a)	5.0%	4.5%	4.2%	3.8%	3.7%
Economic Output (% p.a)					
UK: GVA	1.3%	0.8%	0.8%	1.3%	1.7%
NI: GVA	0.6%	0.4%	0.2%	0.4%	0.7%
UK: GVA per capita	0.6%	0.1%	0.1%	0.6%	1.0%
NI: GVA per capita	0.1%	-0.1%	-0.2%	0.0%	0.3%
Labour market					
UK: Employment rate	76.0%	76.0%	75.3%	74.6%	74.4%
NI: Employment rate	69.3%	69.6%	69.2%	68.9%	69.1%
UK: Unemployment rate	3.9%	4.1%	4.6%	5.2%	5.6%
NI: Unemployment rate	3.9%	3.7%	3.9%	4.2%	4.2%
Housing market					
UK: House prices (% p.a)	3.2%	4.4%	4.7%	2.7%	2.5%
NI: House prices (% p.a)	4.2%	4.6%	4.9%	3.2%	3.1%

In this edition

International and UK developments

A mixed global outlook including slowing Eurozone growth, global trade tensions, high levels of debt and Brexit uncertainty could see global growth slowing in the medium term.

The low wage growth conundrum

With unemployment at record lows, it would be reasonable to assume a higher rate of wage growth than is currently the case. This edition provides some further insight into this low wage growth conundrum.

Forecasting or scenario planning

In this time of elevated uncertainty, economic forecasting could be better described as scenario planning. UUEPC sets out a range of potential economic outcomes.

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: The UUEPC now uses the ILO measure of unemployment.as a measure of the labour force

International and UK developments

The global economy has performed reasonably well over the past two years but risks are increasing and the rate of growth in some major economies is slowing. US economic growth is strong with unemployment at 50 year lows, driven by robust consumer spending and continued fiscal stimulus through lower taxes. A strong US economy supports increased global trade on the back of stronger domestic demand. The International Monetary Fund (IMF) forecasts US growth of 2.9% and 2.7% in 2018 and 2019 respectively.

In contrast, initial signs point to slower Eurozone economic growth in 2018 after a better than expected performance in 2017. The IMF has revised down growth for Germany and France over the next few years and political and economic uncertainty in Italy is a further constraining factor.

Oil prices have increased by approximately 50% over the last 12 months which has boosted the economic prospects of oil rich nations but creates inflationary pressures in advanced economies. However, markets are expecting the price rise to be short lived as higher prices encourage increased supply leading to lower prices in the medium term.

A strong global economy and the competitive Sterling exchange rate boosted UK exports and inbound tourism last year. However, the UK economy experienced a slow start to 2018 with quarter 1 and quarter 2 growth recorded at 0.2% and 0.4% respectively. Much of this was attributed to a combination of poor weather and continued Brexit related uncertainty, but looking forward, growth is expected to pick up in the second half of the year.

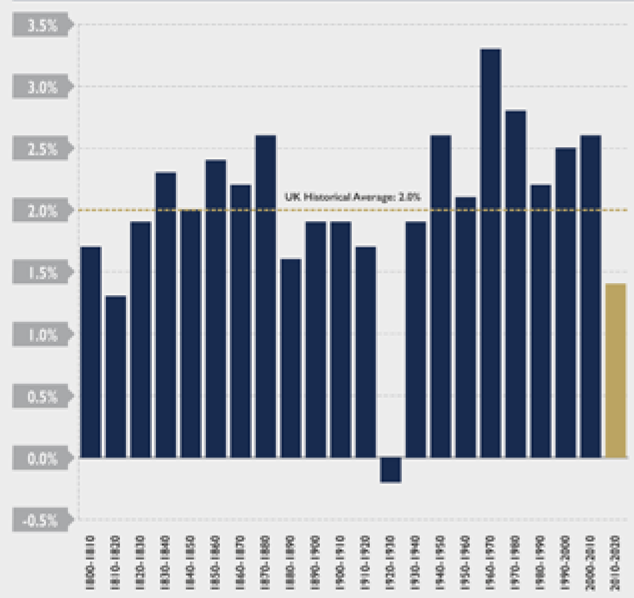
In developing its economic forecasts, the CBR and UUEPC have a forecasting framework based on four key areas of spending, which collectively must increase from one year to the next if economic growth is to be achieved. These four areas are: Consumer spending, Government spending, Investment and Net trade (Exports less Imports).

Consumer spending represents the largest component of economic growth in the UK, accounting for approximately 65% of total output (as measured by GDP). However, as cited in previous UUEPC outlooks, the ongoing reliance on consumer spending as a driver for economic growth is not sustainable. For the first time in 30 years, UK households became net borrowers in 2017, where they spent on average £900 more than they received in income. Combined with low real income growth over the last decade, high levels of consumer debt and a trend towards higher interest rates (albeit slowly), consumer spending cannot continue to increase year on year indefinitely.

The second area of spending relates to Government spending, or fiscal policy, which has been restrained in the last decade. Although this has helped bring down the annual budget deficit, overall public debt remains high. More recently, the Chancellor of the Exchequer received some good news on the fiscal front, public sector borrowing was approximately £6bn lower in the 2017/18 financial year than the Office for Budgetary Responsibility forecasted and borrowing in the current financial year is £8.5bn lower than at the same time last year. This creates some fiscal headroom for the Chancellor and recent announcements including the increase in public sector pay awards suggest that an easing of fiscal policy may help support economic growth.

Investment spending is typically a smaller component of overall GDP. In 1973 (the year the UK joined the EU), investment accounted for 22% of GDP but this has fallen to 17% in 2017. The majority of 'investment spending' relates to business investment with most of the remainder split between government and private sector residential. Although overall investment levels have held steady since the 2016 referendum, ongoing uncertainty in the short term will most likely curtail any significant boost from this spending component.

FIGURE 1: UK ANNUAL ECONOMIC GROWTH PER DECADE SINCE 1800



Source: Bank of England Millenium of Data. Real UK GDP at market prices, geographically-consistent estimate based on post-1922 borders
Note: 2017-2020 forecast using OBR growth rates from March 2018
Note 2: Calculated as compound annual growth rate from each decade

The final component of growth relates to Net Trade. The UK's export base has benefited from a weaker Sterling in the last 12 months and net trade has made a positive, albeit small, contribution to GDP growth. However, more recent data has shown that the 2018 Q2 trade deficit widened despite the weaker pound. Given the uncertain global trading environment and a slowing Eurozone economy (a key UK export market), it seems unlikely a significant boost to exports will emerge in the short term.

Ongoing trade tensions between the US and its major trading partners pose the greatest risk to global economic performance. Avoiding protectionist policies and finding solutions that promote growth in trade (of goods and services) across the globe will be critical to preserving economic growth. Notably the recent signing of the EU-Japan free trade deal shows a welcome response to the recent trend towards protectionism, as would reaching an agreement between the UK and the EU in the current Brexit negotiations.

All things considered, a difficult international environment alongside UK structural economic challenges provide a testing period for economic growth over the next few years. Taking a long-term historical view, the UK economic performance is on course to average the worst decade of economic growth in 80 years, and the second worst economic performance for over 200 years (second only to the 1920's, with mass unemployment in 1920/21 following a short post WWI boom).

The low wage growth conundrum

Low wage growth in an environment of record low unemployment has been a feature for many rich nations over the last ten years. In the decade preceding the financial crisis, nominal wage growth averaged over 4%, but that average has fallen to just 1.8% in the last 10 years. Taking inflation into account, since 2009, wages are down by 5% in NI, 7% in the UK and 4% in Ireland.

Despite a significant reduction in unemployment in recent years, the lack of growth in wages has perplexed economists and Central Banks across the world. NI, despite having the lowest unemployment rate of the UK regions, also has the lowest employment rate due to persistently high levels of economic inactivity. This provides a 'hidden' source of labour and may explain some of the reasons for low wage growth. However, this is a problem across many developed economies and therefore does not fully explain the local experience.

A number of other reasons have been suggested such as: public sector pay caps, declining trade union membership, lower employee wage expectations and high levels of labour supply (free movement of people from Europe). In addition, employers would also point to rising non-wage costs, such as auto enrolled pension schemes, and low productivity growth (the only sustainable long term path to higher wages).

Economic output, as measured by Gross Value Added (GVA) can largely be attributed to total compensation of employees (wages & non-wage costs) and total profits of firms. In 2009, the total wage bill for all employees in Northern Ireland accounted for 57% of total GVA but by 2017, that had fallen to 55% (even though the employment rate increased). In contrast, over the over the same time period the total company profits increased from 35% of GVA to 37%. This points to firms being able to recruit additional staff whilst increasing marginal profits.

Looking forward, this trend may reverse as employers find they need to offer higher wages to attract and retain staff. This is currently the case in central European economies where wages are rising strongly due to labour shortage pressures. In addition, sectors such as manufacturing and agriculture have a high proportion of migrant labour and in a post Brexit world, more limited access to EU labour will add to wage pressures.

Of course other factors will also impact wage growth including the future path of productivity and the outcome of the Brexit negotiations (positive or negative). As discussed above, real wage growth will be critical to support consumer spending and in turn economic growth over the next few years.

The UUEPC is completing research addressing the low wage growth conundrum, the productivity puzzle and implications for future policy direction in NI and will be published later in the autumn as part of a new 'UUEPC Economic Insight' series.

FIGURE 2: FULL TIME WAGE INDEX VS, PEAK LEVELS IN 2009; UK, NI & ROI

Source: ASHE, ONS, CSO, UUEPC analysis
Note 1: Based on annual earnings of all full time workers, converted to real prices (2017 based) using UK CPI from ONS and Ireland CPI from CSO
Note 2: Data based on average annual earnings of all full time employees

Forecasting or scenario planning

Following the 2008 financial crisis, economists were frequently asked why the profession had failed to forecast the largest recession in over a generation. That simple question highlighted some fundamental weaknesses in economic forecasting and although some lessons have been learned, forecasting the performance of a dynamic interrelated global economy is increasingly complex.

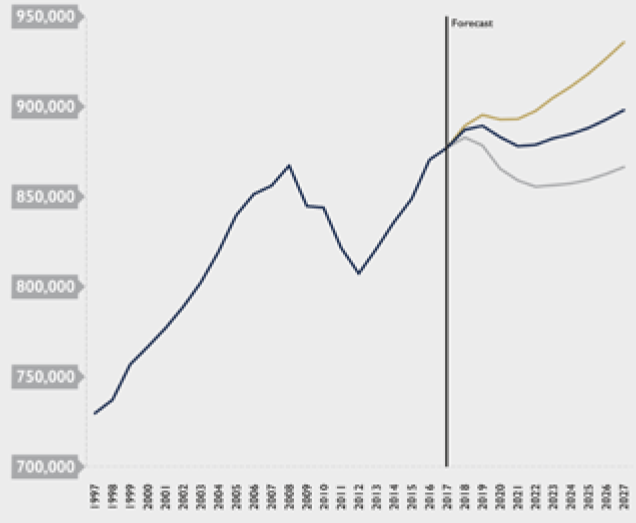
Reflecting these challenges, the UUEPC continues to develop upper and lower case scenario employment forecasts, in addition to its baseline forecast. These scenarios are based on a number of assumptions including, for example, the impact on trade following Brexit, where the level of disruption could range from minimal to significant. Although there is currently no clarity on the future trading relationship, the UUEPC's baseline case is based on a trade friendly agreement being reached between the UK and the EU.

The UUEPC revised upper scenario is based on the assumption of an increase in the employment rate from the current rate of 69% to an ambitious but achievable 73% by 2027. This would bring NI closer to the current UK employment rate of 75% and would result in employment growth of 58,500 additional jobs by 2027.

In contrast, the UUEPC lower scenario assumes a more significant negative impact on trade following Brexit and a reduction in consumer spending caused by a fall in confidence. It produces outcomes close to the lower estimates of independent forecasters suggested by a WTO Brexit scenario. This scenario should be viewed as highly pessimistic and forecasts employment could contract by 10,800 jobs by 2027. Both the upper and lower scenarios are considered to be low probability events.

UUEPC's baseline scenario, our most likely view, is based on the UK and EU reaching a mutually beneficial trading agreement. In addition, it suggests a modest return to growth in productivity per worker of around 0.5% per annum, a rate approximately mid-way between the pre-recession and post-recession decades. This scenario forecasts employment growth of almost 21,000 new jobs by 2027.

FIGURE 3: UUEPC EMPLOYMENT SCENARIOS; 1997-2027



Source: UUEPC Autumn Outlook 2018

Upper Scenario Baseline Lower Scenario

Sectoral outlook

Private sector services

Private sector services remains the main driver of job creation in the NI economy, accounting for almost 50,000 net new jobs since 2012. However, a recent rise in part time work is reflective of a changing economic structure in both the local and UK economies – approx. 40% of new private sector service jobs were part time.

The professional services, admin' & support and ICT sectors have experienced strong employment growth with particular success for roles in computer programming and legal and accounting. Many of these are well paid, high value-added jobs and the outlook remains positive in terms of growth.

Hospitality has been booming in recent years boosted by a competitive exchange rate and significant private sector investment. The sector still has headroom for strong growth in the long term but recruitment challenges are beginning to emerge.

The retail and finance sectors are forecast to experience more challenging times from a job creation perspective as they adapt to changes in customer behaviour moving to online/ digital platforms.

Manufacturing

Manufacturing has been a leading sector of employment growth, creating almost 12,000 employee jobs over the past five years (of which 90% are full time posts). Subsectors including food products, fabricated metals and machinery and equipment have accounted for over half of the total employment growth.

However, the sector has also had to absorb high productivity job loss announcements in recent years. For example, the manufacture of tobacco and beverages sector has contracted by 800 employees since 2015 (largely JTI related). In economy wide employment terms, this is a relatively small number, albeit significant for those directly impacted. Given the sector has an average productivity per job over 5 times higher than the economy average, this has the impact of reducing GVA by 0.6%, equivalent to over £225Mn.

Continued growth in export markets (particularly Ireland), will be critical to support growth for the sector in the next few years. Wider risks including global trade tensions, uncertain future trading relations and potential labour shortages suggests the risks currently dominate on the downside.

Public services

Fiscal constraint since 2010 has led to 2,000 fewer jobs across public services. The health sector has experienced modest growth in employment but this has been offset by reductions in public administration whilst education has been broadly flat.

Changing demographics partially explains the increase in health employment. The over 65's population has grown by 22% compared to only 3% and 2% growth in the 0-15 and 16-64 age categories respectively since 2008. Whilst improving life expectancy is clearly welcome, it also creates long term trend funding pressures.

On a positive note, the UK Government's fiscal position is a little stronger than previously forecast and there may be scope to increase spending. Additional funding has been announced for the NHS in England (and the NI Block Grant will see a boost as a result) and the public sector pay cap for workers in England and Wales has recently been lifted.

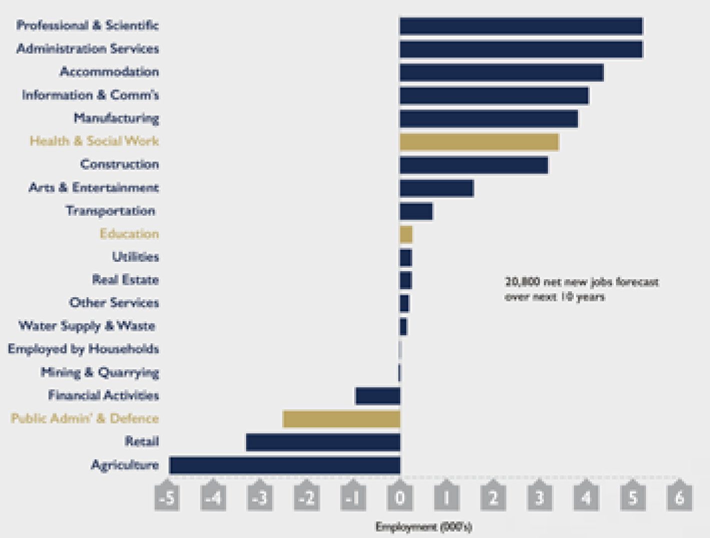
Construction

Construction experienced a reasonably strong 2017 in employment terms adding 3,000 employee jobs, partially offset by a decline in 1,300 self-employment jobs. The sector remains severely impacted from the financial crisis with employment 30% below peak levels.

Furthermore, the sector has experienced a weak start to 2018 with new construction work (two-thirds of total construction output) down 6.7%, and repair and maintenance activity (one-third of total construction output) down 5.1%. Much of this recent slowdown has been attributed as a UK wide issue following the adverse weather conditions. The absence of an Executive is also impacting the sector, as the approval of new public infrastructure projects has stalled.

The outlook remains mixed. Private residential and infrastructure investment should support growth in the coming years but will be held back by a slowdown in public construction projects.

FIGURE 4: UUEPC SECTORAL EMPLOYMENT FORECAST: 2017-2027



Source: UUEPC Autumn Outlook 2018
Note: Predominantely public sector industries shaded

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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.