UUEPC OUTLOOK SUMMER 2021

Light at the end of the tunnel

Unprecedented, like most superlatives, is often overused but it only begins to explain the global health, economic and social events of the last 15 months. Whilst some groups and sectors have struggled more than others, this UUEPC outlook suggests there are grounds for optimism as the economy returns to growth.

This is broadly consistent with other forecasts and gives confidence to both households and businesses which should provide a basis for increased consumer and investment spending. It is now expected that the local economy should return to pre-COVID levels of GVA in mid-2023 and pre-COVID levels of employment in 2024.

Overall, a much more positive picture than was anticipated just a few months ago, but risks remain to broader growth. Most significantly the battle between the pace of the global vaccine roll-out programme and the mutation of the virus.

Key forecasts

Northern Ireland (NI)

	2020	2021	2022	2023	2024
GVA[1] growth rate	-10.40%	5.80%	4.10%	2.20%	1.80%
ILO Unemployment rate[2]	3.10%	4.50%	4.30%	3.90%	3.70%
Jobs growth	-0.90%	-2.10%	1.20%	1.40%	0.80%
Productivity growth	-9.50%	8.10%	2.90%	0.60%	1.00%

United Kingdom (UK)

	2020	2021	2022	2023	2024
GVA[1] growth rate	-9.80%	6.00%	5.30%	1.70%	1.60%
ILO Unemployment rate[2]	4.60%	5.70%	5.50%	5.00%	4.70%

Macro-economic variables

	2020	2021	2022	2023	2024
Interest rates[3] (annual average)	0.23%	0.05%	0.03%	0.14%	0.28%
Inflation[4] (annual average)	0.85%	1.80%	2.20%	1.89%	1.93%

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: 3-month sterling interbank rate (LIBOR)
Note 4: UK Consumer Prices Index (CPI)

The curious case of UK economic performance

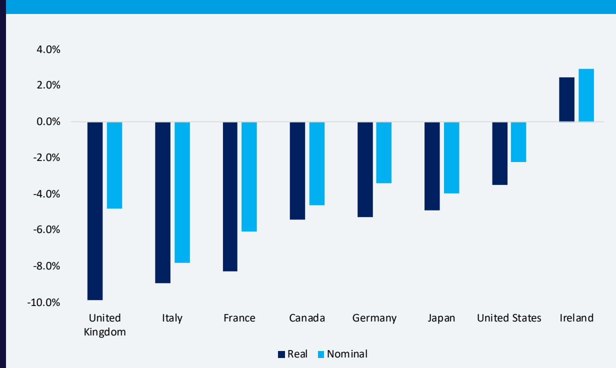
It has been very widely reported that the UK economy has experienced one of the most significant economic contractions relative to other advanced nations. This poor performance has been attributed to a range of factors including a greater reliance on services (in particular, consumer spending) which leaves the economy more vulnerable to lockdowns.

In addition, the UK Government has faced significant criticism for its hesitancy in implementing restrictions in response to COVID at the outset of the pandemic which resulted in an inability to control the virus and in turn brought more economic pain.

Whilst the reasons outlined above are valid, it is less well understood that the UK calculates public sector inflation differently from most nations. The very significant interruption to public sector output in 2020 (i.e. fewer operations undertaken in hospitals and fewer lessons delivered in schools) for similar or higher levels of public expenditure, technically resulted in a high level of public sector inflation. This in turn has significantly reduced 'real' GDP relative to 'nominal' GDP in 2020.

Consequently, the UK's approach to calculating 'real' GDP has had a significant comparative impact, something which would have been negligible pre-pandemic. To highlight this impact Chart 1 shows both nominal and real GDP growth/ contraction of the UK alongside other advanced economies.

Chart 1: Real and Nominal GDP Growth/ Contraction, 2020



Source: ONS, OECD

This highlights that in 'real' GDP terms the UK is the worst performer, but in 'nominal' terms it is in line with other advanced economies – its performance has been 'in the pack'. Importantly, as the UK starts to lift restrictions and the public sector returns to pre-COVID levels of activity, the UK methodological approach should show faster growth than other advanced economies. Given the criticism the UK Government has received in respect of its economic performance over this period, it is surprising that they have not highlighted this issue more widely.

Why does this matter and what does it mean for Northern Ireland?

From a Northern Ireland perspective, Government spending represents a greater proportion of GDP than the UK average. In previous recessions this would have cushioned the local economy from some of the more severe impacts but this time around the calculation approach should show an exaggeration of the UK impact i.e. more severe contraction but faster recovery.

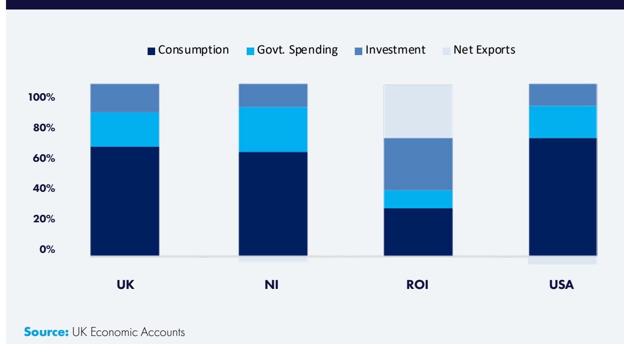
The extent to which both the UK and NI will experience a faster recovery is discussed further below. However, posting strong economic growth numbers could have a positive impact on household and business confidence, which in turn could help sustain consumer spending and business investment. Whilst many economies are rebounding quickly as restrictions are lifted, the ability to sustain growth beyond the initial boost is critical to longer term wealth creation and importantly restoring the public finances.

The consumer and the coiled spring recovery

The Bank of England Chief Economist, Andy Haldane, has been very bullish about the prospects of a UK economic recovery. Household finances have improved significantly for many as their spending has been curtailed during lockdown and the level of enforced savings has created the basis for a consumer-led spending bounce. It is likely that the successful vaccine roll-out programme has raised consumer confidence and therefore the conditions exist for the economy to rebound like a "coiled spring".

Consumer spending is the largest component of the UK economy and is high by international standards (Chart 2), hence the importance always placed on household finances to overall economic growth. Therefore, a strong recovery in consumer spending should go a long way in reversing the economic slump.

Chart 2: Components of Economic Activity, 2020



Source: UK Economic Accounts

Reliance on consumer spending is also very significant in the Northern Ireland economy and is another reason the local economy would have experienced a severe contraction on a scale similar to the UK. However, importantly it also suggests a sharp recovery as restrictions are lifted.

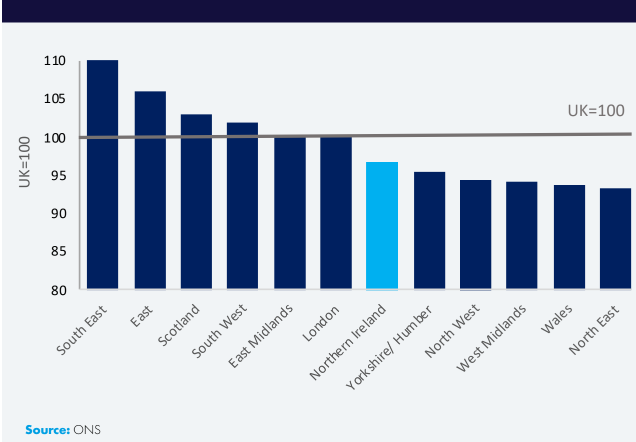
This is good news in the short term, but the sustainability of any growth phase will depend on a wide range of other factors such as the strength of economic growth across our main trading partners. In addition, the way in which consumers choose to spend their money is also important. If there are significant purchases of imported goods, then leakage will be high and growth would be lower than if spending is focused on goods and services produced locally.

Will the coiled spring apply in NI?

Although the Bank of England has estimated that additional savings across the UK is approaching £200 billion, these savings are not evenly distributed. Previous UUEPC research has shown that those in lower income groups have been more impacted by the pandemic than high earners, indicating that the additional savings have been accumulated by the more affluent.

Northern Ireland is ranked 7th out of the 12 UK regions in median household income after housing costs, 3.25% below the UK average (Chart 3). This suggests that the level of additional savings and hence the boost to consumer spending may also be marginally lower in NI than across the UK as a whole, but importantly a boost should still be expected.

Chart 3: Median household income after housing (3 yr ave), Indexed, 15/16 – 17/18



Source: ONS

NI growth prospects still relatively good

Overall the short-term prospects for the local economy are positive. As outlined above, the reliance on both Government spending and consumer spending explain the scale of the contraction relative to performance elsewhere, but both factors should be a positive in terms of the pace of recovery.

The UUEPC anticipate growth of 5.8% in 2021, following a contraction of 10.4% in 2020, and a return to pre-COVID levels of GVA in 2023 compared to mid-2022 for the UK as a whole and a return to pre-COVID levels of employment in 2024. This is much more positive than was anticipated at the outset of the pandemic.

The labour market has also held up well

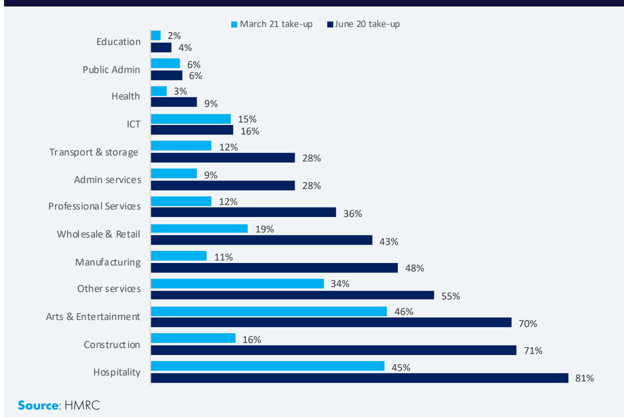
Of the 35k jobs lost over the last year, 25k were self-employed, mainly in Construction and Other Services (close contact services such as hairdressers and beauticians) and of the 10k employee jobs lost, three quarters have been from the Hospitality and Retail sectors.

Importantly though, an economic catastrophe has been averted by the unprecedented supports offered by Government. At its peak in June 2020, approx. 240k jobs were furloughed in Northern Ireland (or 30% of total employee jobs). As restrictions eased over the summer, that fell sharply to a low of 65k in September but has subsequently risen and was 99k in March 2021.

The numbers supported are now less than half of peak levels even though strict public health restrictions were in place over this period. This is a combination of more businesses being able to adapt to the restrictions and fewer sectors being prevented from trading. As with all things COVID related, the impact varies across sectors.

The percentage take-up of furlough is significantly lower across almost all sectors between June 2020 and March 2021 (Chart 4), but remains high in Hospitality and Arts & Entertainment, with 45% and 46% respectively of jobs still furloughed. Other sectors such as Construction and Manufacturing furloughed significant numbers in the first lockdown, and whilst most have been able to return to work, given the size of those sectors, almost 10k Manufacturing jobs and 6k Construction jobs remain furloughed. Nevertheless, in March almost all industries across the private sector, still had more than 10% of eligible jobs furloughed.

Chart 4: Furlough take-up rate by sector, NI, June 2020 and March 2021



Source: HMRC

What happens when furlough ends?

There is a risk that 2020 may be regarded as the year which saw unemployment postponed rather than avoided. As the government supports begin to taper, firms could start the process of making significant numbers of furloughed staff redundant. Under the current CJRS, employers will have to contribute 10% to salaries in July and 20% in August and September after which the scheme is scheduled to end.

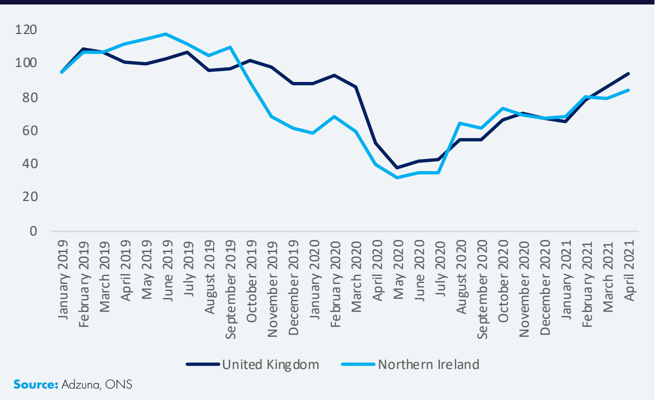
Since November 2020, employers have had to meet the cost of National Insurance and pension contributions for their furloughed staff. Intuitively, that would have been the point when firms would have started the process of letting staff go, therefore it is encouraging that a spike in unemployment did not occur at that time.

There is limited data on local employer intentions in respect of their furloughed staff. However, the ONS Business Impact of Coronavirus Survey (BICS) data indicates that 11% of businesses intend to return people from furlough, compared to just 3% who intend to make redundancies and 20% who are not sure. No firm conclusions are possible, but this suggests that most of those on furlough should return to work.

Vacancy data also provides optimism

The number of vacancies fell dramatically in the first half of 2020 (Chart 5), but recovered in the second half of the year and the NI vacancy rate is now 84% of the 2019 average. The recovery in the UK has been stronger and currently sits at 94% of the 2019 average.

Chart 5: Indexed vacancies, NI and UK, January 2019 – April 2021 (2019 average = 100)



Source: Adzuna, ONS

The sectoral data (only available for the UK) shows high levels of demand in areas such as engineering, healthcare, ICT, logistics and facilities management. In contrast, vacancies in retail, catering, administration and hospitality are well below pre-pandemic levels, all sectors where furlough levels remain high. Locally, given the recent lifting of restrictions, there is increased anecdotal evidence that hospitality employers are struggling to fill vacancies and one would expect this to be reflected in the official data over the next few months.

Overall, whilst the vacancy data gives grounds for optimism, there may be skills mismatches between those at risk of losing their job and the job opportunities available. This raises policy implications about the need for job search supports and skills assistance to reallocate labour from one sector to another.

Sectoral Inflection Points

The pandemic has accelerated some trends and potentially reversed others which has raised the prospect that there will never be a complete return to the 'old normal'. This raises fundamental issues for a range of sectors.

Retail

The High Street was facing significant challenges pre-COVID, particularly from the on-line threat. The restrictions have required people to increase their proportion of shopping online and enforced a change in behaviour in those who had previously been reluctant to adopt technology. Across the UK, internet sales have increased steadily from 3% in 2007 to 19% in 2019, but then jumped to 28% in 2020 where consumers spent on average £2.1 billion per week.

In a post-COVID environment, people will still want to shop in physical stores but the proportion of total retail spending in those shops is likely to continue to fall in the longer term. Retailers will continue to develop their online platforms and a transfer of activity to larger distribution centres and transport and logistics companies seems likely.

Hospitality and Arts & Entertainment

These sectors have been the most impacted by the health restrictions put in place and the inability to trade has caused significant financial strain for many businesses. However, in the longer term, for those businesses that survive, demand for Hospitality and Arts & Entertainment services is likely to be very strong. If anything, the pandemic has made people much more appreciative of the social experience.

The prospects for overseas holidays remains in the balance and therefore it seems most likely that overall volumes in 2021 will remain low by historic standards. This means lower numbers of inbound travellers but a more captive domestic market and an increase in stay-cations.

Aerospace

International air travel is likely to face restrictions for longer than most other areas of the economy and concerns about new variants will mean that restrictions are likely to be lifted slowly. Furthermore, there is a growing consensus that leisure travel will return to pre-pandemic levels if passengers feel safe, but there is greater concern about the extent to which global business travel will return to previous levels. This is a particular issue for airlines as business travellers fly more frequently and pay premium prices.

This has a direct impact on the aerospace sector, which is a very important employer in the local economy. It is critical that this sector is supported through these challenging times because if these businesses close in the short term, they are highly unlikely to re-open when demand returns because of the high barriers to entry of this industry.

Professional Services, ICT and the office market

Some sectors have adapted well to the pandemic and the shift to home working has been relatively smooth, such as in Professional Services and ICT. These sectors have tended to work from relatively expensive offices in urban centres and with the shift to home working, there was an emerging view that businesses could reduce costs by allowing staff to work from home indefinitely. However, more recently the value of physical proximity to work colleagues from a staff management and staff development perspective has been realised.

This changing view was reflected in the KPMG CEO Pulse Survey in March 2021 where 17% of CEOs expected to cut their office space post-COVID, compared to 69% in August 2020. This points to some consideration of a move to a hybrid model, but the office will remain a fixture for many years to come.

Sectoral employment actual and forecast (000's)

Industry	2008-12 (Recession)	2012-20 (Recovery)	2020-30 (Forecast)
Agriculture	0.8	-2.6	-0.5
Mining & quarrying	-0.2	0.0	0.0
Manufacturing	-11.1	15.3	3.5
Utilities	0.0	0.9	0.1
Water supply & waste	0.4	1.8	0.6
Construction	-25.9	8.7	5.3
Retail	-13.1	4.1	-9.4
Transport & Storage	-0.6	4.5	2.5
Hospitality	-1.0	7.4	4.9
ICT	-1.0	7.1	5.0
Financial services	-1.5	0.5	0.6
Real estate	0.2	1.0	0.3
Professional & scientific	-0.1	10.8	8.6
Administration services	-3.3	8.9	3.3
Public Admin' & defence	-4.6	-6.9	1.2
Education	-1.7	5.9	2.4
Health & social work	3.2	20.3	6.4
Arts & entertainment	0.1	1.0	2.3
Other services	-0.3	4.7	1.6
TOTAL	**59.7**	**93.3**	**38.5**

Is inflation on the rise?

The UUEPC maintains a benign inflationary outlook over the short term, but with the scale of global quantitative easing funding huge levels of government spending, the prospect of higher inflation is creeping back onto the economic agenda.

Inflation currently sits at 1.5% and has been below 2.5% for most of the last 25 years, which may create a complacency and an under-appreciation of the risks of rising inflation. Commodity prices are determined in international markets, and with major economies such as the US and China quickly returning to growth, upward inflationary pressure is inevitable.

Copper and iron ore prices have more than doubled since the trough of the pandemic and foodstuffs such as corn, soyabeans and wheat have experienced similar scales of increases. These commodities are all trading well above their pre-pandemic levels. The Bank of England has identified rising energy prices as one of the key drivers of inflation in the short term. Chart 6 below shows the recent increase in crude oil prices.

Chart 6: Brent Crude Oil, £ per barrel, January 2019 – April 2021

Source: Indexmundi

Higher inflation means higher interest rates and that is a problem for both households and perhaps more significantly, governments who have borrowed huge sums and are running multi-decade high deficits. A combination of high deficits and high interest rates would be very damaging for the global economy.

However, there are counter arguments, many families have experienced a significant reduction in their income over the last year and the aggregate response of households remains uncertain. Although the labour market has held up well, some will lose their jobs when furlough ends, and others may be in fear of losing their jobs which could lead to increased precautionary savings.

On balance therefore, inflation will most likely rise above 2% as the year progresses and then fall back within the Bank of England's target range in the medium term. But for all the reasons outlined above, continued low inflation is no longer a safe assumption and will remain an area of increased focus moving forward.

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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