UUEPC OUTLOOK SPRING 2023

Resilient performance but low growth

In general, economies have proved more resilient to recent global challenges than many analysts had anticipated at the turn of the year. Although energy prices have fallen from stratospheric levels, they remain elevated, inflation has proved to be 'stickier' than expected and as a result central banks have been relatively aggressive in raising interest rates. This is set against a geopolitical context where the war in Ukraine appears to have morphed into a war of attrition and relations between the US and China remain strained.

This is hardly a pro-growth backdrop, but surprisingly major economies have avoided falling into recession. The local economy has followed this general trend of very low growth, even by post-financial crisis levels. Longer term prospects may be more positive, however, with the signing of the Windsor Framework and improved relations more generally between the UK and EU.

In the short term locally, the return of a functioning Executive will be seen as a priority, but this in itself does not alleviate the difficult decisions that need to be taken.

Key forecasts

Northern Ireland (NI)

	2023	2024	2025	2026	2027
GVA [1] growth rate	0.1%	1.1%	1.9%	1.8%	1.6%
ILO Unemployment rate [2]	2.9%	3.1%	2.9%	2.8%	2.6%
Jobs growth	0.2%	0.2%	0.4%	0.5%	0.7%

United Kingdom (UK)

	2023	2024	2025	2026	2027
GVA [1] growth rate	0.2%	1.4%	2.5%	2.4%	2.1%
ILO Unemployment rate [2]	4.1%	4.4%	4.2%	4.0%	3.8%

Macro-economic variables

	2023	2024	2025	2026	2027
Interest rates [3] (end of year)	4.75%	4.0%	3.5%	3.0%	3.0%
Inflation [4] (Q1 forecast)	10.2%	3.0%	1.0%	0.4%	-

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 (annual average)
Note 3: Bank of England Base Rate
Note 4: UK Consumer Price Index (CPI)

The underlying demographic challenge

In recent years high profile global events have dominated the headlines, and as a consequence slower moving but equally significant economic trends have been overlooked. The changing nature of population demographics should be a growing concern for policy makers, governments, and employers in the coming years.

The working-age population (16-64 year olds) is typically the source of an economy's workforce and currently 72% of this age group are employed. However, growth of the NI working age population has started to slow significantly, between 1980 and 2010 it increased by 270k (approximately 90k per decade), in the 2010s it increased by only 15k and projections for the 2020s suggest an increase of just 3k, before a likely decline thereafter. This trend is not unique to NI or the UK but is global in nature. Therefore, the current recruitment and skills challenges faced by employers is likely to persist in the long term.

Preventing stagnation in output growth in a constrained labour market will be an increasingly important policy priority and some potential solutions include:

- **Increased business investment** – businesses will become more incentivised to increase investment in technology and automation alongside increasing the capacity of their staff, through higher levels of skills development. This will require changes in behaviour for many firms because, for example, Northern Ireland has the lowest proportion of businesses engaged in product or process innovation in the UK [1].

- **Re-engaging the economically inactive** – NI consistently reports the highest rate of economic inactivity across the UK, of whom approx. 46k have indicated that they would like to work. Providing affordable childcare, increasing flexibility in the workplace, addressing issues with the welfare system and changing employer attitudes to those with disabilities should all help integrate the inactive back into the labour force.

Fortunately, these solutions are well recognised and already prioritised in Government strategies. However, moving forward further steps will need to be taken and migration may become a more important policy tool.

- **Increased immigration** – since EU enlargement in 2004, NI tended to attract migrants from Eastern Europe who typically filled lower paid, lower skilled roles. Many then left during the pandemic and with post-Brexit migration rules, have been less inclined to return. However, those new migration rules have been much more attractive to higher skilled workers from outside Europe, and the UK overall has experienced a significant increase in migrants from India who are filling different skills gaps in the economy.

Given these changing demographics and migration trends, there is an increased risk that some employers could decide to re-locate their activities overseas. Historically this has been a greater factor for the manufacturing sector but with technological changes and significant improvements in communications, this could become more of an issue in the services sector.

It is also worth acknowledging that this is not a one way street, there is also an emerging global trend of near-shoring, which is seeking to shorten, rather than lengthen, supply chains. This could make NI an attractive location for overseas investment.

Chart 1: Working age population projections, selected countries, 1997-2050

Source: World Bank, UUEPC analysis
Note: Indexed 1997 = 100

Looking at other large economic regions, the demographic challenge is clear. Almost all parts of the developed world are entering a long-term decline in their working age populations and these projections suggest the EU and China face the most significant issues. In contrast Ireland has enjoyed large growth over the last 20+ years and this is forecast to continue into the mid-2030s before it starts to decline. The US is the developed world's outlier where working age population growth is forecast to continue through to 2050. The UK is forecast to tread a middle path, with a broadly static working age population, performing more strongly than NI.

Although not presented in the chart, developing world demographics are very different and are forecast to grow strongly. For example, India which has just become the world's most populous nation, is likely to see its population continue to grow strongly until at least the mid-2040s. Therefore, from a migration policy point of view, it is likely that attracting workers from developing economies rather than Europe will be more sustainable in the longer term.

[1] - UK Innovation Survey

Business dynamism for a healthy economy

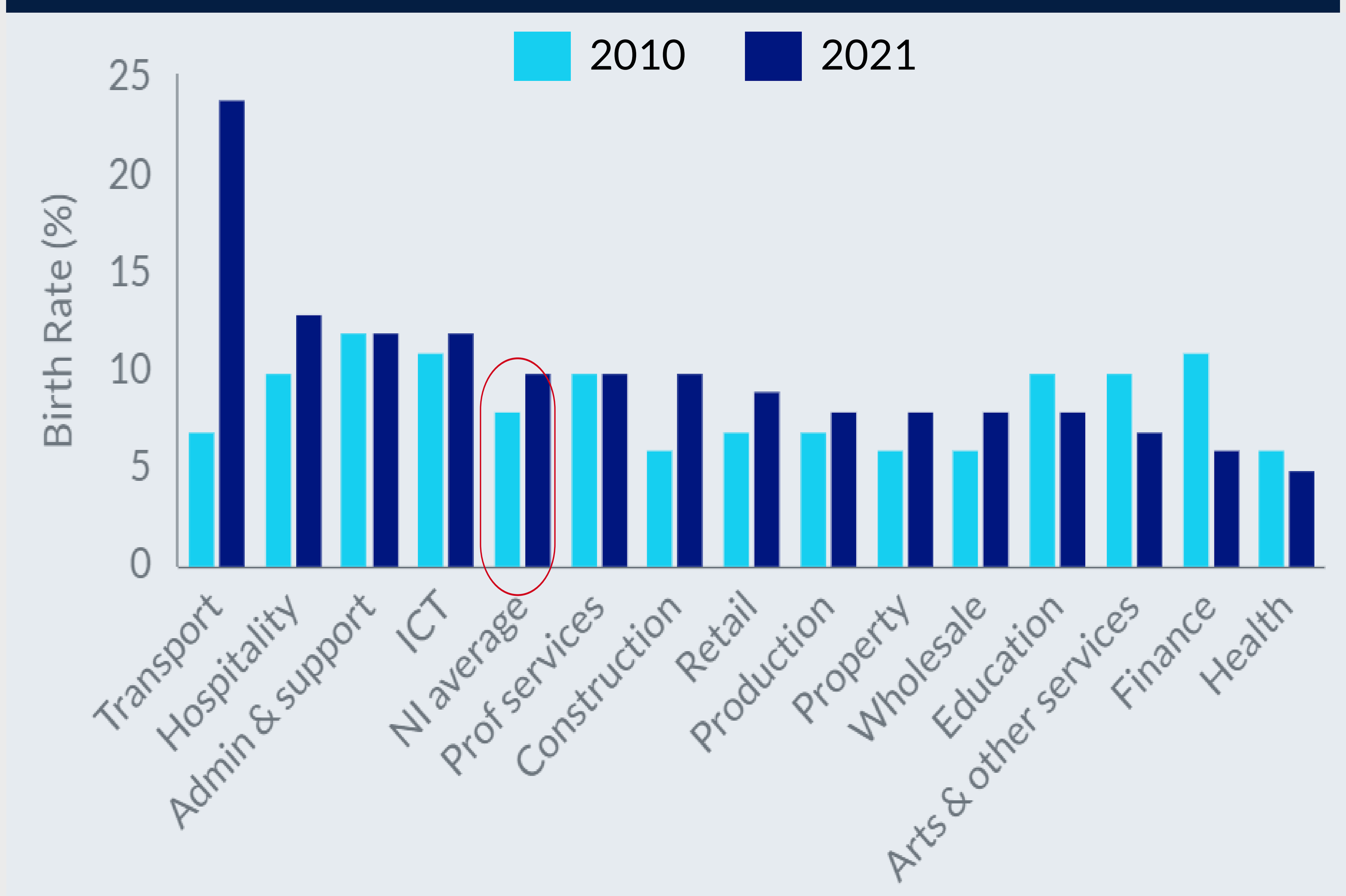
Business dynamism reflects the rate at which new firms enter and existing firms leave the market. A high rate of business dynamism is considered an indicator of a healthy economy reflecting greater levels of innovation, competition, productivity and job creation. Whilst there are further elements of business dynamism an upcoming UUEPC report assesses rates of firm entry and exit by sector in NI to understand the economic impact, particularly on productivity.

Increasing business births but in low productivity sectors

Between 2010 and 2021 business births in NI rose by 45%, reaching 6,655 in 2021 and the business birth rate (births as a percentage of the active business population) increased from 7.8% to 10.3%. Although this increased birth rate is a positive trend, it is the lowest across the UK constituent countries.

Four sectors have an above average birth rate. Transport & Storage had the highest birth rate at 24% in 2021, an increase from 6.8% in 2010. This significant increase is an established trend for the sector, which saw the birth rate rise to 9% in the 2013 to 2015 period, then 12% (2016-18) and 21% (2019-21). Transport is then followed by Accommodation & Food, Business Admin and ICT. Of these sectors only ICT has above average productivity. In contrast Health, Finance, Arts & Entertainment and Education have experienced a declining business birth rate, albeit two are public sector dominated.

Chart 2: **Business birth rates by sector, NI, 2010-2021**



Source: **NISRA**

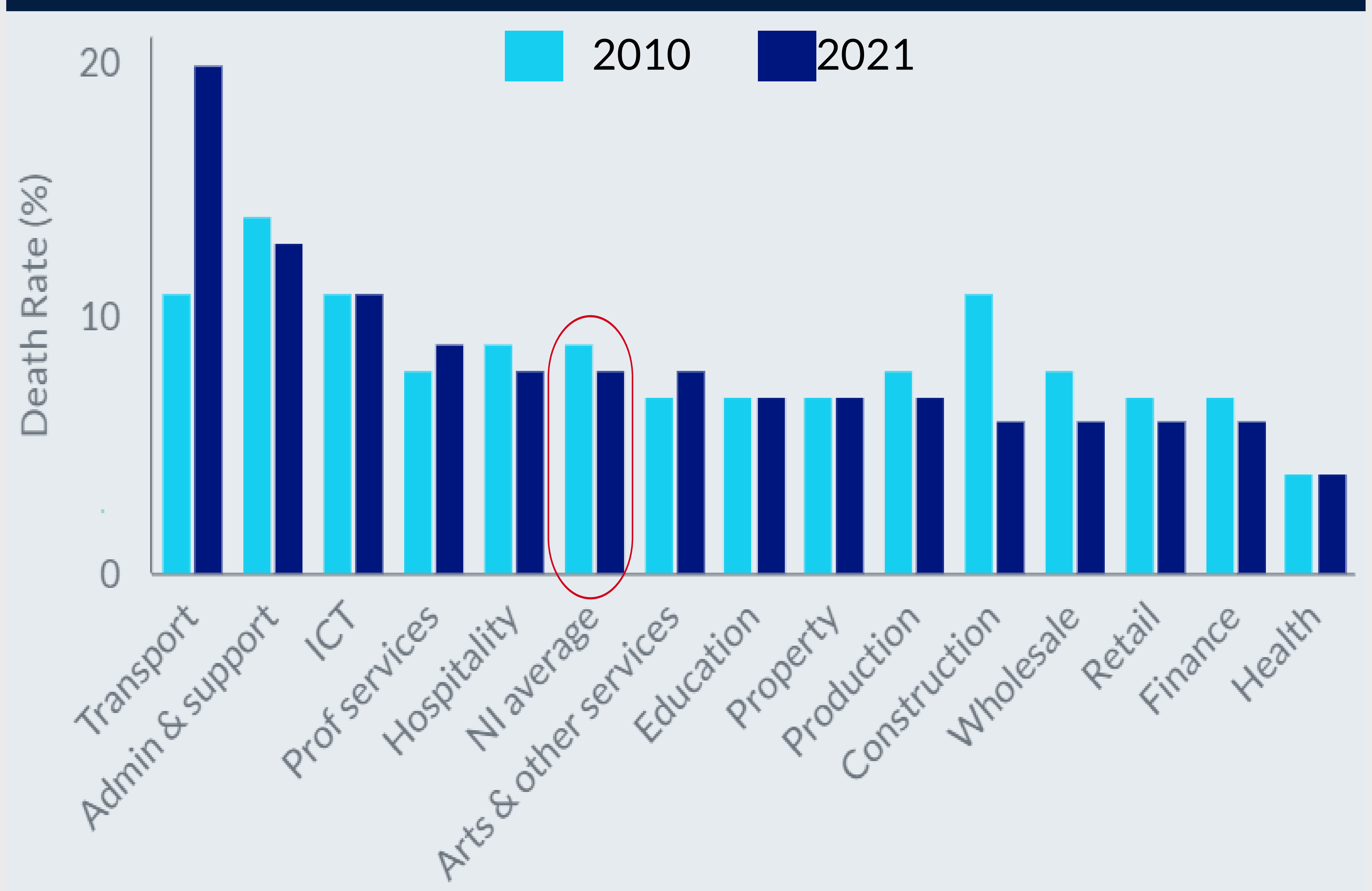
Despite annual volatility, the number of firm deaths in NI was the same in 2010 as in 2021 at 5,200 and the death rate fell marginally from 8.8% to 8%. This is also the lowest death rate across UK constituent countries.

Given NI has both the lowest business birth and death rates, the business churn rate (birth rate plus death rate) at 18% (2021) is also the lowest (Scotland 22%, Wales 25%, England and UK 24%). This low business churn rate indicates a less dynamic economy and potentially contributes to NI's lower level of productivity.

Business birth and death rates are highly correlated in part because not all start-ups survive, therefore sectors with a high number of births also tend to experience a high number of deaths. Overall, most sectors have experienced a marginal decline in their death rate since 2010. The Construction sector is one outlier, which has experienced a significant reduction in its death rate, most likely reflecting higher failures in the aftermath of the Global Financial Crisis.

The other big exception is Transport which has experienced a very significant increase in churn (high births and deaths) over the last decade.

Chart 3: **Business death rates by sector, NI, 2010-2021**



Source: **NISRA**

Is churn leading to productivity improvements?

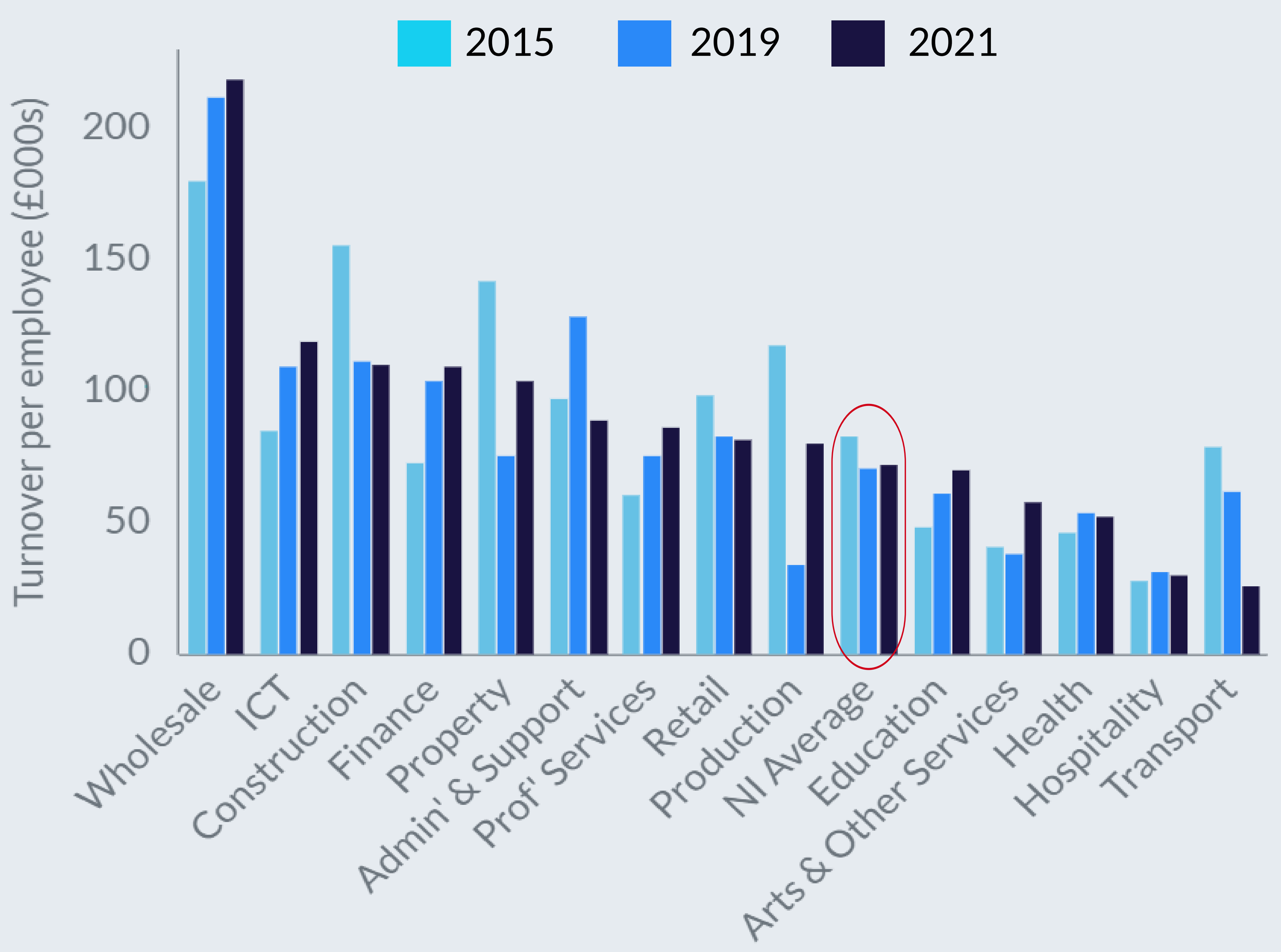
The business churn rate has increased only marginally over the decade, from 16.6% in 2010 to 18.3% in 2021. An increasing churn rate is positive if firms entering the market are more productive than those exiting. However, the evidence for NI suggests that there is often little difference in the productivity levels (using the proxy of turnover per employee) of entering and exiting firms and in some sectors the productivity of businesses exiting exceeds those entering.

The average labour productivity (turnover per employee) of entrants by sector dropped from £83k in 2015 to £73k in 2021, which may be explained by trading difficulties during the pandemic.

Turnover per employee in business births in ICT increased from £85k in 2015 to £119k in 2021, an increase of 29% and also had an above average birth rate of 11.9% in 2021. The Finance and Professional Services sectors have both also experienced consistent growth in turnover per employee over the 2015-21 period.

Transport and Hospitality had the highest birth rates, but the lowest levels of turnover per employee for firm births at £27k and £31k respectively in 2021. This represented a significant reduction for the Transport sector with low turnover for new starts. This may be partially explained by the impact of the pandemic on the sector and therefore productivity of new starts in this sector should be monitored.

Chart 4: NI business births productivity (turnover per employee), 2015-21



Source: ONS, UUEPC

Turnover per employee for business deaths also fell from £86k in 2015 to £75k in 2021 (a broadly similar fall for business births £83k to £73k). The sectoral breakdown indicates that the turnover per employee for businesses leaving was higher than those entering in Production, Transport & Storage, Retail and Accommodation & Food. For all other sectors, new businesses had a higher turnover per employee than those exiting.

Encouragingly, high productivity sectors such as Construction, ICT and Professional Services all showed higher levels of turnover per employee for new entrants than those exiting. This is positive for continued productivity growth and overall the birth rate in these sectors is around the NI average.

Table 1: NI business birth and death productivity (turnover per employee), 2021

Industry	Births £000s	Deaths £000s
Production	80.9	138.4
Transport	26.6	40.6
Retail	82	89.3
Hospitality	30.5	32.9
NI average	**72.6**	**75.0**
Construction	110.2	106.7
Finance	110.1	102.8
ICT	119	109.8
Health	52.5	48.4
Prof' Services	86.7	75.3
Admin' & Support	89.2	75.1
Wholesale	218.7	167.5
Property	104.2	77.5
Education	70.7	48.4
Arts & Other Services	58.2	32.9
UK average	**92.4**	**94.3**

Source: UUEPC estimates of ONS data

Policy interventions to support a more dynamic and higher value-added economy, include:

- **Supporting births** provides a more effective mechanism to improve productivity, and prevent a stagnating economy, than interventions preventing deaths. However, focusing on any and all business births will not necessarily raise productivity. Rather, the focus should be on **supporting those with a capacity for innovation and growth**.
- **Targeting support at more knowledge-intensive entrants** within lower productivity sectors could help those sectors increase their overall productivity and become industry leaders for incumbents.
- **Understanding obstacles preventing start-ups** in higher productivity sectors can help develop support packages to encourage greater numbers of higher value-added start-ups.
- **Accessing capital and a skilled labour force for productive sectors** is essential for productivity improvements to be sustained.

Sectoral forecasts

Manufacturing

The manufacturing sector continues to experience high levels of input costs and the latest Purchasing Manager Index (PMI) reports a decrease in activity. In addition, with a more settled relationship between the UK and EU more generally following the signing of the Windsor Framework, greater clarity on the future trading relationship should increase confidence. There also exists a window of opportunity to increase foreign investment following the goodwill generated by recent political visits linked to the 25th anniversary of the Belfast/ Good Friday Agreement.

As a consequence, the outlook for the sector is positive, but challenges remain. Manufacturing is an energy intensive sector and therefore high energy costs remain a concern along with the long-term requirements to transition to net zero. Like other sectors, recruiting and retaining skilled staff is also major business issue.

Construction

The construction sector has also had to deal with significant energy and input (materials) cost increases, and although the upward inflationary pressures are easing, the cost of doing business remains much higher than pre-Covid and pre-Ukraine.

The outlook is mixed for the sector, new residential development activity is constrained because of capacity issues in other infrastructure (most notably wastewater). Commercial development is facing significant uncertainty due to higher interest rates, and hybrid working is impacting both future office development and urban centre retail. The longer-term outlook is much more positive, significant capital investment in renewable energy is required as well as retrofitting existing commercial and residential properties.

Private sector services

Whilst the labour market remains tight by historic standards, vacancy data at the UK level would suggest that pressures in areas such as professional services have started to ease and are below pre-pandemic levels. Vacancies in other sectors such as retail, transport and facilities management have also reduced since the end of 2022 but remain above pre-pandemic levels. This reflects the higher interest rate environment needed to bring inflation back to target which is having a cooling effect on the labour market, but employment levels are approaching record high levels again.

Overall, private sector services are forecast to continue creating significant numbers of jobs over the next decade. Retail remains an area where long-term contraction is likely, but this will be small in proportion to the overall size of the sector.

Public sector services

On average, public-sector workers have seen their real wage grow by just 0.5% per year between 2000-2022. This puts in context the current levels of industrial action across the public sector which in turn has a ripple effect across the rest of the economy. Historically, high levels of industrial unrest have always coincided with periods of high inflation. Governments then attempt to control inflation by constraining wage growth but at a time when costs are typically increasing at pace. It is no surprise that strike action follows.

The financial pressures in Stormont are also well publicised and for the first time it appears that the Department of Education budget could be reduced. Historically it has enjoyed protection along with Health. A return of the Executive only puts the difficult decisions onto local politicians, it does not change the decisions that have to be taken.

The longer-term employment outlook for the public sector will likely see the greatest increase in Health. This reflects greater demand for health services associated with an ageing population and underlines the need for wider reform in the health service.

Sectoral employment actual and forecast (000's)

Industry:	2012 - 2019	2020 - 2022	2022 - 2033 (baseline)	2022 - 2033 (upper)
Agriculture	-4.9	-5.4	0.1	0.8
Mining & quarrying	0.1	0	0	0
Manufacturing	18.2	1.2	3.6	6.5
Utilities	0.8	0.1	1.0	1.5
Water supply & waste	1.6	0.2	0.1	0.7
Construction	7.5	-4.2	5.9	6.6
Retail	7	-1	-2.3	0.9
Transport & storage	5.5	0.7	3.6	5.1
Hospitality	8.9	1.8	5.2	6.2
ICT	6.6	0.3	6.5	9.4
Financial services	0	-0.3	1.8	2.9
Real estate	0.4	-0.5	0.3	1.5
Professional & scientific	11	4.1	6.8	8.9
Administration services	14.7	4.8	2.4	3.6
Public admin' & defence	-6.1	2.7	0.1	1.5
Education	4.8	5.4	0	1.2
Health & social work	13.7	-4.5	7.0	8.9
Arts & entertainment	2.3	-0.2	1.3	2.3
Other services	9.8	1.1	1.9	3.2
TOTAL	**101.8**	**6.4**	**45.3**	**71.6**

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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