UUEPC OUTLOOK SPRING 2022

Ulster University

Strong growth, but risks abound

Economies across the world are continuing to post strong growth and appear to have overcome the latest challenge from the Omicron variant which emerged in November. Although growth slowed in the final quarter of 2021 due to the restrictions introduced, both the NI and UK economies should reach their pre-COVID levels of GVA earlier in 2022 than previously anticipated.

However, significant risks to growth remain and many of them are global in nature. Not least the deteriorating situation in Ukraine, which will have devastating humanitarian consequences as well as exacerbate existing economic risks. This includes even higher energy prices for industry and households, the potential for a shortfall in energy supplies and other key commodities, escalating supply chain issues and the risk of targeted cyberattacks against western physical and financial infrastructure.

Although this creates a highly uncertain backdrop to this forecast and it is too soon to anticipate the scale of the economic impact, the published data shows that locally the primary concern of business remains access to talent and the main constraint to growth is unfilled job vacancies.

Key forecasts

Northern Ireland (NI)

	2020	2021	2022	2023	2024
GVA(1) growth rate	-9.6%	7.7%	4.2%	2.1%	1.8%
ILO Unemployment rate(2)	3.1%	3.6%	3.6%	3.3%	3.1%
Jobs growth	-0.9%	-2.5%	1.5%	1.0%	0.7%

United Kingdom (UK)

	2020	2021	2022	2023	2024
GVA(1) growth rate	-9.7%	7.5%	4.5%	2.1%	1.3%
ILO Unemployment rate(2)	4.7%	4.6%	4.5%	4.3%	4.2%

Macro-economic variables

	2020	2021	2022	2023	2024
Interest rates(3) (end of year)	0.1%	0.25%	1.25%	1.75%	1.75%
Inflation(4) (annual average)	0.9%	2.6%	5.9%	4.0%	2.4%

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
Note 3: Bank of England Base Rate
Note 4: UK Consumer Prices Index (CPI)

Is inflation transitory?

Over the last six months concerns about inflation have increased significantly, this is a global issue with US inflation at a 40-year high and both UK and European inflation at a 30-year high. The consistent view of central banks was that the price rises were transitory and caused by pandemic related short term factors which would pass through allowing inflation to return its 2% target rate. However, as inflation has proved to be less transitory than expected, further analysis has highlighted other long term global trends emerging which could bring an end to this extended period of low inflation (and low interest rates) internationally, nationally as well as locally in NI.

The following factors are driving the increase in inflation in the **short-term**:

- The sudden increase in demand following the lifting of restrictions coincided with pandemic induced supply chain disruptions and an associated increase in transportation costs;
- Geo-political tensions in Eastern Europe had already led to higher energy prices for households and businesses creating cost push pressures across the economy. The war in Ukraine has the potential to exacerbate those issues significantly and perhaps for an extended period of time; and
- The risk that an increasingly tight labour market could lead to above inflation wage demands has been exercising the Bank of England. Although an issue in a small number of sectors, there is limited evidence that this is currently taking hold across the economy, but could be an area to monitor.

As these short-term factors have a cumulative effect, inflation expectations are raised which creates a cycle of staff demanding higher pay increases and firms raising prices. Thus higher inflation expectations often leads to higher inflation becoming established in the medium term.

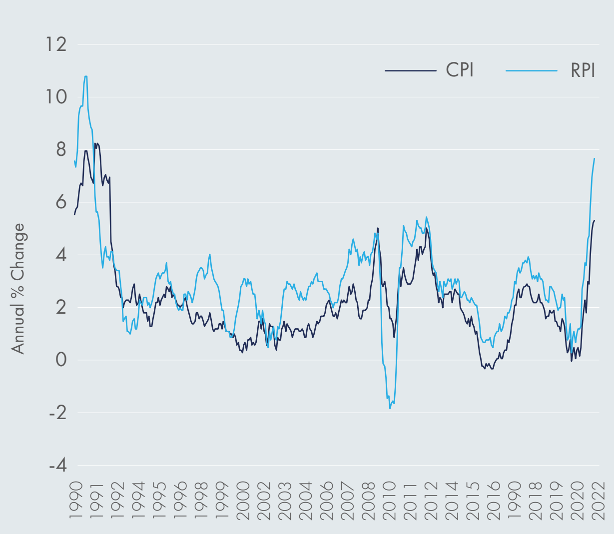
In addition, several **longer-term** global trends are emerging which also suggest that many of the deflationary factors that kept prices low over the last two decades will be less relevant in 2020s. These include:

- The longer term implications of the war in Ukraine remain highly uncertain, but the dynamic of the energy relationship between Russia and Europe has changed significantly and possibly on a permanent basis. This would most likely lead to permanently higher energy prices globally;
- Linked to Europe's likely pivot away from Russian gas, will be an increased emphasis on environmental sustainability and the drive to net zero. This transition will only be achieved over the very long term and costs are likely to be higher during the transition period;
- Over an extended period of time, the Chinese economy enjoyed an almost endless supply of low cost labour which kept wages down and in turn the price of goods for export to western markets. However, this trend is slowing as demographic challenges start to take effect and therefore upward cost pressures are emerging;
- Reduced migration from eastern to western Europe is contributing to the vacancy problems across the entire continent, pushing up the bargaining power of labour and hence wage costs;
- There may be a risk that the negative impacts of the extended period of Quantitative Easing are starting to emerge and a new long term cycle of monetary tightening has started.

The latest inflation data shows that some of the biggest increases in prices have come from clothing and footwear; housing and household services; and furniture and household goods. This suggests that inflation is becoming less short-term as price rises are feeding through to a broader range of consumer goods.

Some have argued that central banks have been too slow to recognise this new trend, but the Bank of England and US Federal Reserve have both started to raise interest rates. In contrast, the ECB had until recently suggested that their first interest rate rise would not occur until 2023, but with more recent data suggesting increased inflationary risks, the ECB President is now indicating that a rate rise this year is more likely.

Chart 1: UK Inflation, CPI and RPI, 1990 – 2022



Source: ONS

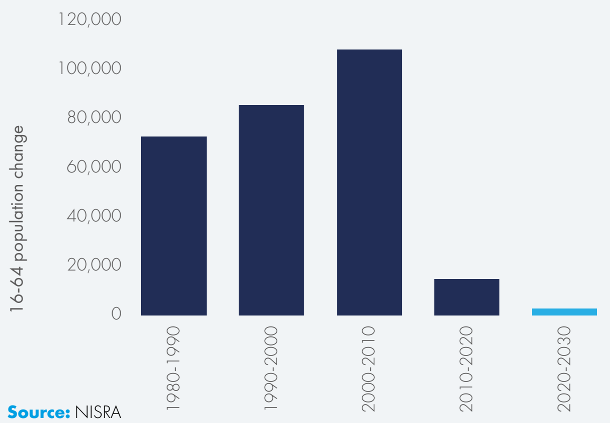
The supply of people and skills is the key challenge for the 2020s

Demographics is not on our side

Despite the seriousness of the challenges experienced over the last two years and the risks facing the global economy looking forward, businesses continue to highlight access to talent as the main issue they face. This points to the success of the extensive support measures put in place by regional and national governments to mitigate against the public health restrictions imposed. As the scale of the potential impact of the pandemic became apparent, it seemed that mass unemployment would be the likely outcome rather than unfilled vacancies and skills shortages. Nevertheless, these are the policy challenges governments must now work to resolve.

More recently in addition to a lack of skills, many employers have started to raise a more fundamental issue around a lack of people. Although this has been attributed to the pandemic causing many migrants to return home, this situation has been developing for several years. For three decades from 1980 to 2010, the working age population in Northern Ireland increased by over 260k. However, in the last decade those aged 16-64 increased by just 15k and in the 2020s it is forecast to increase by less than 3k (Chart 2)

Chart 2: Change in the 16-64 population by decade (NI)



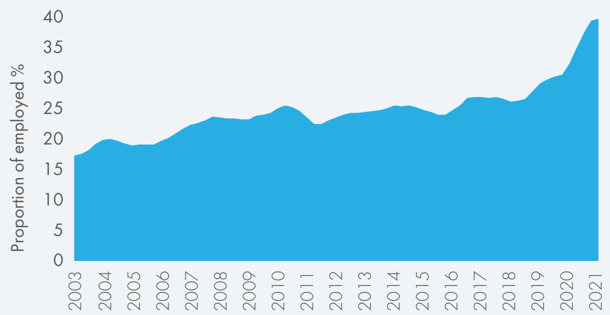
Source: NISRA

This suggests the supply of labour problems faced by employers is likely to be long standing. The obvious solution to the 'number of people' issue is to increase inward migration, but these trends are also concerning. From 2010 to 2020 Northern Ireland averaged approximately 15k National Insurance Number applications from non-UK nationals each year. In 2020/21, the number of applications fell below 2k. Whilst there is clearly a pandemic impact, it is far from certain that immigration will return to the levels experienced previously.

The modern labour market is more qualifications hungry

The skills mix in the labour market has also changed very significantly over the last twenty years (Chart 3). In 2003, 16% of the Northern Ireland labour market had at least a NQF level 6 qualification (i.e. a degree qualification or above) and by 2021 this had more than doubled to 37%. The corollary of this position also holds and over the same time period, from 2003 to 2021, the proportion of people in the labour market with a below NQF Level 2 qualification (i.e. less than 5 GCSEs including Maths and English) fell from 30% to 15%. There are several factors driving this trend:

Chart 3: NQF Level 6+ (% of total employed), NI, 2003-2021



Source: Labour Force Survey, UUEPC analysis
Note: Figures are based on 4-quarter rolling average

- Generational impact – older people typically have lower levels of formal qualifications and younger people typically have higher levels of qualifications, therefore as older people leave the labour market and younger people join, the qualifications intensity of those in employment increases. This has been a long established trend.
- Sectoral mix factors – the sectoral structure of the NI economy is also changing which is impacting the skills mix. Sectors such as agriculture, which have a larger proportion of employees with lower levels of formal qualifications, are now employing fewer people. In contrast, sectors such as ICT and professional services are growing and they demand a much higher qualifications profile. This is also a long established trend.
- The COVID factor – the latest data also highlights a significant increase over the last two years in the proportion of the labour market with at least a NQF Level 6 qualification, rising from 25% in Q1 2019 to 37% in Q2 2021. In contrast those with a below NQF Level 2

qualification fell from 21% to 15% over the same time period. This is a very significant change in such a short time and suggests that employers were more likely to make staff with lower level qualifications redundant whilst firms in high skills sectors continued to recruit.

- This is also reflected in other data, where those with higher level qualifications saw their hours worked increase in 2021 to an all time high, but conversely those with lower level qualifications saw their hours worked drop significantly. In short, the pandemic economy places a much greater value on higher level qualifications.

Unpacking the brain drain issue

Discussion of the skills issue in Northern Ireland quite often leads to a debate on the need to reduce the brain drain, where too many of our brightest young people chose a university outside NI and do not return home after graduating. The number of places for NI students in local HE institutions is restricted due to the Maximum Student Numbers (MaSN) cap. However, 73% of young people from NI wishing to continue their studies at university, do so at a local HE institution, with the remainder studying elsewhere (mostly in GB). This is the second highest retention rate across all 12 UK regions (see Chart 4).

Scotland has the highest retention rate (over 90%), which is unsurprising given Scottish students do not have to pay tuition fees to study at a Scottish university. It is perhaps also unsurprising that Northern Ireland is placed second given tuition fees here are significantly lower than in England and Wales.

The situation after graduation is also positive. Approximately 80% of locally born graduates are working in NI 15 months after they graduate (irrespective of where they studied). This is also the second highest retention rate across all UK regions, behind Scotland, again suggesting retention is not the primary issue.

Attracting young people to study in NI must be the priority

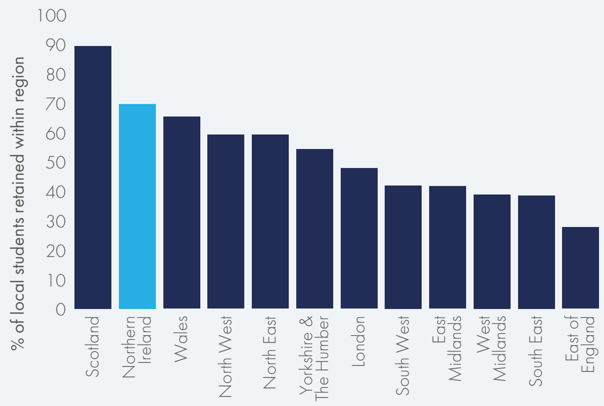
Although NI's outflow of students to other regions is relatively low, the inflow of students from other regions is the lowest in the UK by a significant margin (Chart 5). Only 6% of students in NI HE institutions come from other parts of the UK. This results in NI having the largest net outflow of students of any UK region. This poor record of attracting talent raises two important considerations:

- It places increased importance on retaining talent, which may be challenging given the already relatively high retention rate and the desire for some young people to benefit from life experiences elsewhere; and/or

- It increases the need to attract a wider pool of talent to study (and ultimately work) in NI.

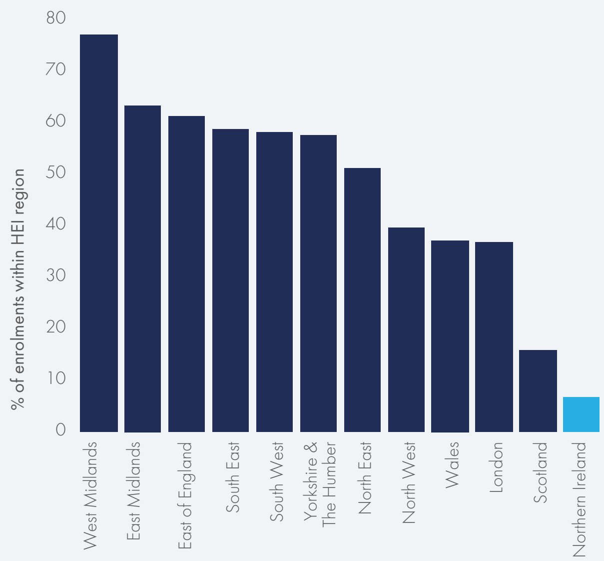
Recent research by Pivotal[1] on local people who left NI to work and/or study in GB highlighted several issues which, if resolved, could increase both retention and attraction of talent. These issues went beyond identifying more favourable economic opportunities and strong links between work placements and degree courses but also included poor community relations, ineffective government and a lack of leisure options and diversity of the education offering. This creates a need to improve NI's international image and reputation so it is recognised as a great place to live, work and study.

Chart 4: Proportion of HE enrolments within region of domicile, UK regions, 2019/20



Source: HESA

Chart 5: HE inflow from other UK regions (% of UK domiciled within region), UK regions, 2019/20



Source: HESA

[1]Pivotal (2021) Should I stay or should I go? Reasons for leaving Northern for study or work

Sectoral forecasts

Manufacturing

Although the manufacturing sector closed during the initial wave of restrictions, the implementation of public health mitigations allowed the sector to return to work within a relatively short number of weeks. In this regard the impact of COVID was, relative to other parts of the economy, reasonably limited, however the interconnected, just-in-time nature of global supply-chains has been significantly disrupted. This continues to be an issue for the sector both in terms of access to inputs as well as the cost of transportation.

The manufacturing sector covers a broad range of sub-sectors and although the overall performance has been strong there are a small number of sub-sectors which have been more significantly impacted. These include aerospace, automotive (NI produces intermediate goods for the automotive sector) and the food service sector (those servicing the hospitality trade).

The final issue is the Northern Ireland Protocol, which provides local manufacturers with both opportunities and challenges. Access to both the UK and EU markets is a potential benefit to local manufacturers as well as a selling point for inward investment. However, the arrangements for goods being imported from GB is causing significant challenges for many firms and adding to costs.

Construction

The construction sector also returned to work within a relatively short period of time after the initial lockdown and has already returned to pre-pandemic levels of activity. However, supply chain interruptions have significantly increased the cost of inputs which creates issues around viability of projects as market prices now often exceed tender prices. In the longer term, there are concerns around the pipeline of projects and the level of public funds available for infrastructure projects.

Private sector services

Private sector services is the largest part of the economy but business conditions vary significantly within the sub-sectors. For example, professional services and ICT adapted very quickly to the pandemic with many firms discovering a flexibility in their IT infrastructure they did not know existed and that the transition was easier than they had anticipated. In contrast, sub-sectors such as hospitality and leisure have had a much more challenging time, faced with either very severe lockdown restrictions or public health messaging that significantly reduced demand from customers. Although restrictions have been lifted and optimism is returning, many businesses are now carrying a significant debt load which could take several years to clear and will reduce investment at least in the short term.

Public sector services

Public services are particularly difficult to forecast at this time because the level of economic activity and employment across the public sector is entirely dependent on government spending. In 'normal' times it is usually relatively easy to make a determination on a government's direction of travel in terms of spending. Governments usually signal their intention either to increase or restrain spending and that policy stays in place for at least the period of that parliament. Although the current Government signalled the 'end of austerity' at the start of its mandate, the public finances are now stretched due to the pandemic. Therefore, the Government's ability to increase spending in the years ahead (whether as part of its levelling up agenda or clearing health waiting lists) is going to be limited. As a result, the forecast indicates a relatively modest increase in public sector employment over the coming decade, and this will be primarily focused on health.

Sectoral employment actual and forecast (000's)

Industry:	2012-21 (Recovery)	2022-30 (Baseline)	2022–30 (Upper)
Agriculture	- 8.9	1.3	1.6
Mining and quarrying	0.1	- 0.1	0.1
Manufacturing	14.1	5.3	7.7
Utilities	0.9	0.1	0.9
Water supply & waste	1.6	0.8	0.9
Construction	2.1	7.6	7.9
Retail	- 4.1	- 1.6	1.0
Transport & Storage	3.6	4.1	4.7
Hospitality	5.8	5.4	5.5
ICT	5.8	6.1	8.3
Financial services	- 0.7	1.8	2.8
Real estate	0.7	0.9	1.1
Professional & scientific	13.0	7.5	10.3
Administration services	9.6	3.9	4.7
Public Admin' & defence	- 5.5	0.4	1.6
Education	9.3	0.5	1.4
Health & social work	18.9	9.1	9.8
Arts and entertainment	2.4	- 0.4	1.6
Other services	2.2	5.6	5.1
TOTAL	**70.9**	**58.3**	**76.8**

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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www.communities-ni.gov.uk

Department for the Economy
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