REGIONAL FORECASTS

Challenging times - Autumn 2008 forecasts

Economic forecasts and projections – EDF monitoring

September 2008

REGIONAL FORECASTS,
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Executive Summary

September 2008

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Challenging times

At the time of writing (September 2008) the UK economy exhibits a higher level of confusion than at any time in the last sixty years. Although not quite as alarming as in the USA, conditions in the UK financial sector are unprecedented for several generations. Part of this involves contagion from the US financial meltdown since UK financial institutions own large volumes of US financial instruments that have proved of uncertain or low value, thus endangering their balance sheets. Uncertainty about the financial stability of banks has led to a general reluctance to lend, a process now known as the 'credit crunch'. This in turn has precipitated a steep decline in UK house prices. Prices have fallen around 10% across the UK over the last year, and are likely to repeat this degree of decline over the next year. Much of this decline in house prices would, in our view have occurred anyway, but the precise timing of the house price declines has been determined by the 'credit crunch'.

Part of the problem is home grown in that levels of bank lending to the UK household sector reached historic highs by 2007 and have since been shrinking. Household debt (mainly mortgages) which had been equal to 100% of household income in 1997 reached 177% by 2007. This huge expansion of debt underpinned the rise in house prices, and also supported the rapid expansion of consumer spending and hence GDP over the last decade. Conversely, the current and likely future contraction of mortgage lending is bound to reduce the growth of GDP over the next few years. Difficult financial conditions have recently been compounded by a sharp rise in world commodity prices which have further reduced levels of consumer spending in real terms. Although temporary, this spike in commodity prices has been sufficient to dissuade the Bank of England from following the US authorities in reducing interest rates to a level that would have eased the impact of the financial squeeze.

Much of the UK's economic turmoil to date has been confined to the financial sector and to housing markets. These financial and house price problems are now having an impact on the wider economy. Employment in the finance and construction sectors are falling and unemployment has begun to rise. Oxford Economics' expectation is that GDP will remain broadly flat in the UK through 2008 and rise only slightly in 2009. Employment is expected to fall in 2009 and 2010 leading to a rise in claimant unemployment to around 1.2 million.

These national economic conditions are not surprisingly having a direct impact on the Northern Ireland economy since it is closely bound to UK economic cycles through common interest and exchange rates as well as public spending and trade. While Northern Ireland is insulated from some of the direct effects of the credit crunch by the small size of its financial sector, the extra-ordinary rise in house prices in 2007, (rising to a level 60% overvalued compared to Scotland) will take years to rectify. The huge downturn in house sales is having important impacts on the construction sector and on services related to housing including estate agents and conveyancing. Northern Ireland was badly affected by the early 1980's recession in which high exchange rates damaged manufacturing, but largely escaped the early 1990's recession in which high NI's low level of indebtedness insulated it from the damage wrought by very high interest rates. In the current downturn Northern Ireland is likely to share the pain at least proportionately with the rest of the UK. Some factors suggest a stronger downturn in NI. The direct fall-out from declining house prices will be greater than in GB, while slower increases in public spending will have more effect than in other UK regions. In addition, the end of the long revival in the retail and wholesale sectors will soon end, removing another source of relatively rapid growth. On balance however the |Oxford forecast suggests a short-term downturn of similar magnitude to the UK average.

The forecasts in this report reflect the Oxford Economics baseline view of the UK and Northern Ireland economy. The uncertainties of the current economic situation mean that base-line projections must be accompanied by caveats. The downside risk is, in our view greatest. Short-term recession could be deeper than projected here, and longer-term growth may be lower if lending remains muted for a long period. It is this longer term outlook which is the main focus of this report, since it is oriented towards economic targets largely expressed relative to the UK as a whole. This executive summary covers the key EDF goals, with additional explanatory data explaining the underlying trends. It begins with a discussion of the potential alternate futures and concludes with a quantification of the scale of challenge in achieving convergence with UK averages[1].

Looking forward – a scenario approach

Given the uncertainties surrounding the current short-term outlook it is useful to set the forecast in the context of a set of 'alternate futures'. The EDF indicator forecasts are consistent with the Oxford Economics baseline which would be towards the upper end of expectations across independent advisors. Hence it would be reasonable to take the view that a downside alternative is more likely than an upside. The position for 2008 is already established by partial and provisional data. GVA growth in the UK for 2008 is available in provisional estimates, since the growth is from mid-year to mid-year and we have GVA estimates up to the second quarter of 2008. The data suggests that growth in GVA in the UK is a little over 1% in 2008, although most of this 1% appears to have occurred in late 2007.

Table ES.1: GVA growth, alternate scenarios

	Base case	Lower growth	Economic crisis
Likelihood	**50%**	**40%**	**10%**
2007	2.52	2.52	2.52
2008	1.29	1.20	1.00
2009	0.53	0.00	-0.75

Source: *Regional Accounts, Oxford Economics*
Note: *Baseline forecast is the primary forecast used in this Summer 2008 forecast report*

For Northern Ireland we have employment estimates up to the second quarter of 2008 and can estimate GVA in 2008 by making the reasonable assumption that productivity trends follow the UK average. This gives an estimate that GVA growth for 2007-8 in Northern |Ireland has been 1.3%. The Oxford forecast for GVA in 2008-9 is for slower growth at 0.5%. At this low level the Northern Ireland economy would be close to recession and unemployment would be increasing quite rapidly. Our estimate is unemployment might be 8,000 higher by mid-2009. Supporting evidence for this short-term forecast is as follows.

- **Industry** - has been buoyed by an increasingly favourable exchange rate but demand is slowing in most of Northern Ireland's major external markets. The NI Index of Manufacturing Production shows 2008 Q1 output at 3% above the same quarter of 2007, but below the level of the previous quarter
- **Construction –**Until recently output has been boosted by a number of major infrastructure projects including the development of Victoria Square, the Westlink and major school / road development programmes. These helped construction materials firms and service sector industries supporting these projects (consultancy and design for example) to enjoy strong growth. Several of these have now ended and the SIB programme of public sector infrastructure development has peaked. There are no plans as yet to bring forward future public spending projects.
- **Public services –** the 2008 Budget anticipates spending in current prices rising by only 4.2% per annum over the period 2007-10. This is slower than the 6% per annum rise in the previous three years, and coincides with a period of higher inflation. The increase in real terms may be close to zero, providing little boost to a major part of the economy.
- **Financial and Professional services** – sectors such as consultancy and advertising have been performing strongly in recent years but now face slower public spending,

[1] Note that the PfG excludes the Greater South East in convergence challenges.

and a contacting construction market. There is some business to be found supporting restructuring and rationalisation but this will not compensate for losses in property and legal services. Financial services will be directly affected by falling demand and bad debts in other sectors. It remains to be seen whether turbulence in the UK financial sector will impact on call centres within NI. The potential supply of new call centre jobs to Northern Ireland has remained buoyant until recently, but falling demand for such services is likely to lag the downturn in the sector internationally and may begin to emerge next year.

- **Labour market** – redundancies data remains down on a year ago (up to April 2008), but unemployment rose by 800 in the latest month.

The major risk to the outlook is depicted in the **lower growth scenario** in Table ES.1. This is that the second half of 2008 proves to be very weak with growth falling away across a broad range of sectors and typified by the following:

- **Construction** - job loss accelerates in the second half of the year as house prices fall further and land banking of sites gathers pace
- **Retailing** - is hit hard by reduced spending from consumers facing budgetary pressures and job loss begins to occur as profits fall sharply
- **Professional services** - begin to feel the effects of lower demand for financial advice, advertising, market research and legal services as demand for services in land transactions tapers off and current 'riding out' attitudes to the slow down are reversed and labour is shed.

The **economic crisis scenario** in Table ES.1 explores an altogether more alarming outturn where the economic problems deepen and the economic stalls as opposed to flattens, underpinning this would be:

- **World conditions** - A precipitous fall in economic conditions in the second half of 2008 given ongoing pipeline projects and world demand remains unlikely at the time of writing. US demand is holding up reasonably well, but recession is expected in GB
- **Sharp housing led contraction** - Job loss in construction and the sectors dependent upon house sales (financial advisors, mortgages staff, legal services etc.) escalates quickly and most firms in the sector report losses.
- **Retailing contraction quickens** - Job loss accelerates in retailing and associated leisure and hotels sectors as consumers cut back markedly on spending.
- **Public sector delays** - Major public sector projects stall due to nervousness of market conditions or financing challenges
- **Investment weakens** - The already slower flow of FDI falls away further as the global economy slows.
- **Financial and business services** – profit collapse
- **Confidence eroded** - General confidence across the NI economy is lost – impacting on migration, investment and spending intentions locking the economy down to a much more modest growth trajectory as attitudes of risk aversion and conservatism come back to the surface of the NI economic psyche.

On balance the baseline is in our view most likely outcome (and the one upon which this EDF forecast report is based) but it is worth noting the probability of the lower growth scenario has risen steadily over recent weeks and it cannot be discounted. Problems of inflation, a lack of decisive local powers and falling confidence lead us to only present downside scenarios. The risk of growth exceeding the baseline is very modest indeed.

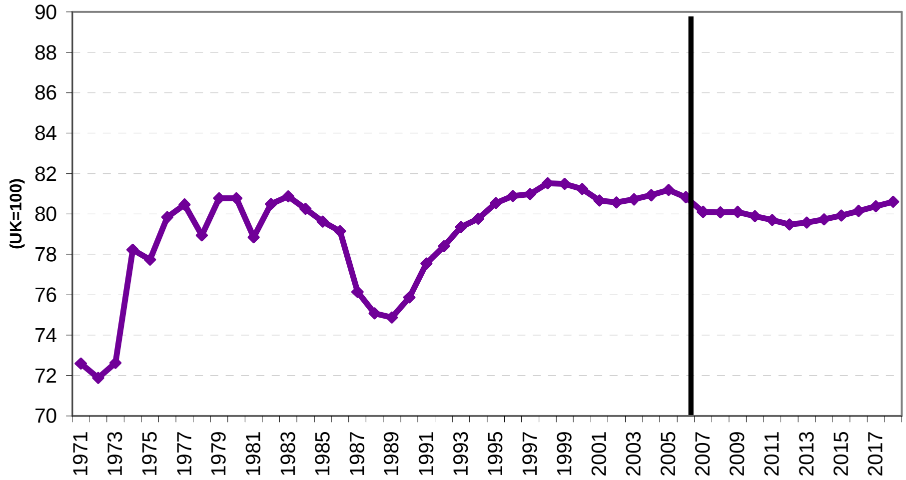
Forecasts - EDF goals

Forecasts for the EDF goals are presented below from the baseline forecast (Autumn 2008) along with supplementary information and explanation. Additional commentary and comparator data is provided in the main report together with monitoring tables and data.

GVA per person

The first EDF goal and most frequently quoted indicator of economic growth, GVA per head relative to the UK average, has been stubbornly low in NI despite good labour market growth over recent years. NI has been on a plateau at 81% of the UK level for many years. The 20% differential with the UK average is partly explained by too low a proportion of the population being in work (recent migrant flows have allowed job growth to take place without employment rates rising by much as might have been otherwise expected). The productivity gap is also partly explained by lower GVA per worker. Our forecast is for little measurable progress in GVA per head over the decade ahead, indeed some weakening is possible in the short run as job creation is insufficient for the growing working age population, despite a lack of significant in-migration in the baseline.

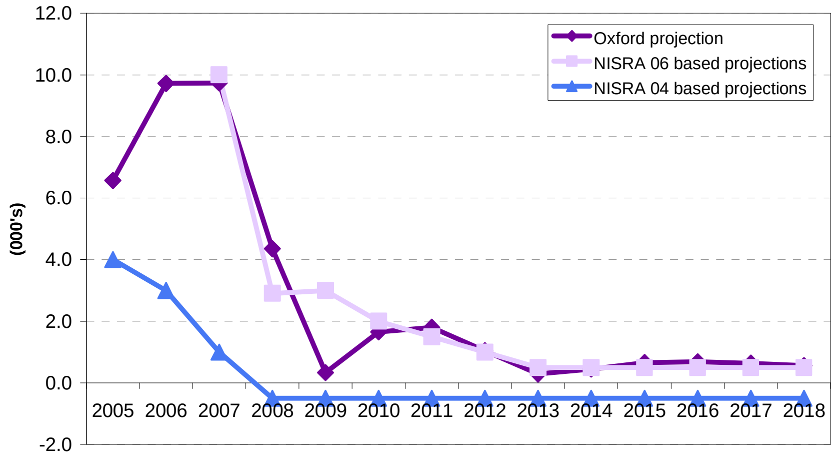
Figure ES.1: Goal: GVA per person in Northern Ireland relative to the UK (UK=100)



Source: *ONS, NOMIS, NISRA, Oxford Economics*
Note: *2005 is the last published GVA data*

The underlying components of this forecast for GVA per head require some consideration starting with population, which forms the denominator in the calculation. Oxford's current model suggests population growth will fall back from recent high levels as net migration declines in response to weaker labour market conditions and high house prices (even with substantial projected falls in house prices). In recent years Oxford's model has suggested official population projections under predict migrant flows into the UK but we now suspect that under the current economic cloud the official outlooks may be too high now that the economy is slowing. If net migration into the UK were to fall back even more sharply, then the GVA per head would improve relative to the baseline forecasts, presupposing that job and output growth in the baseline could be maintained. As figure ES.2 shows the Oxford forecast is now similar to the latest official outlook with only a minor level of net in-migration through the forecast period. The Oxford forecast, which is independent of the NISRA projection, is for a sharp contraction in net migration in 2008. This is generated mainly by high relative house prices (which deter in-movers). Contraction in job opportunities, especially in construction, is a larger factor for international (mainly East European) immigrants.

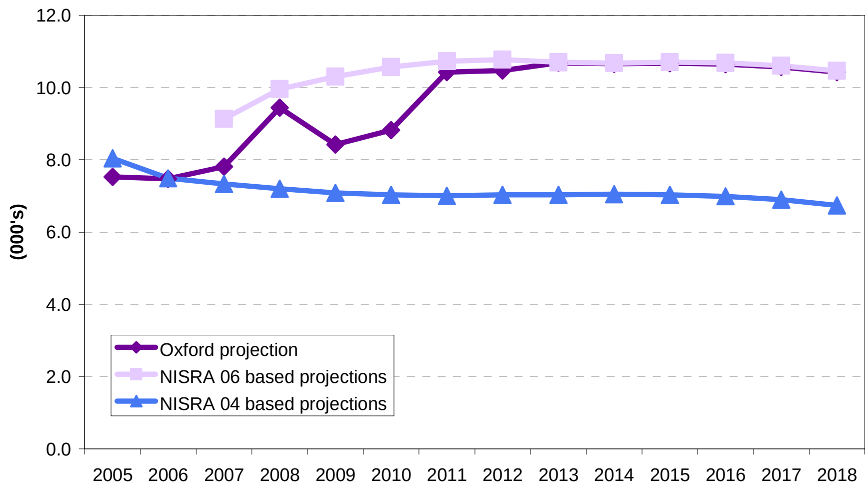
Figure ES.2: Migration projections (000's)



Source: Oxford Economics, NISRA

Forecasts for natural increase (births minus deaths) are significantly higher than in previous reports. These are based on previous official estimates (figure ES.3) and largely mirror official NISRA projections. This increase, which is at both extremes of the age spectrum (more births, longer life expectancy), and thus not of working age, has an adverse effect on GVA per capita estimates due to an increase in dependents relative to those at work.

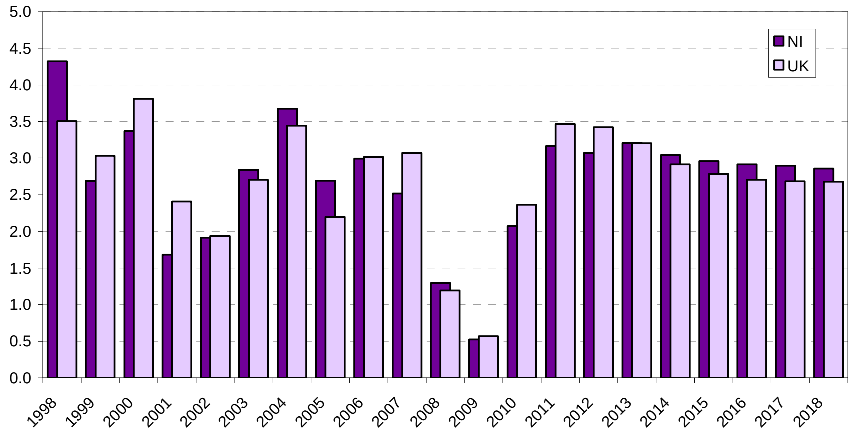
Figure ES.3: Natural increase projections (000's)



Source: Oxford Economics, NISRA

Summarising the outlook for GVA per head, Northern Ireland is expected to fall behind the UK in 2008 and 2009 and with a more muted recovery phase. The gap widens in 2010 and 2011 after growth in GVA above the UK average in 3 of the last 4 years. In the longer term Northern Ireland's growth in GVA creeps above the UK rate as construction recovers and retail resumes an albeit modest, supplementing more consistent growth in financial and business services and manufacturing.

Figure ES.4: GVA growth, NI & UK (%)

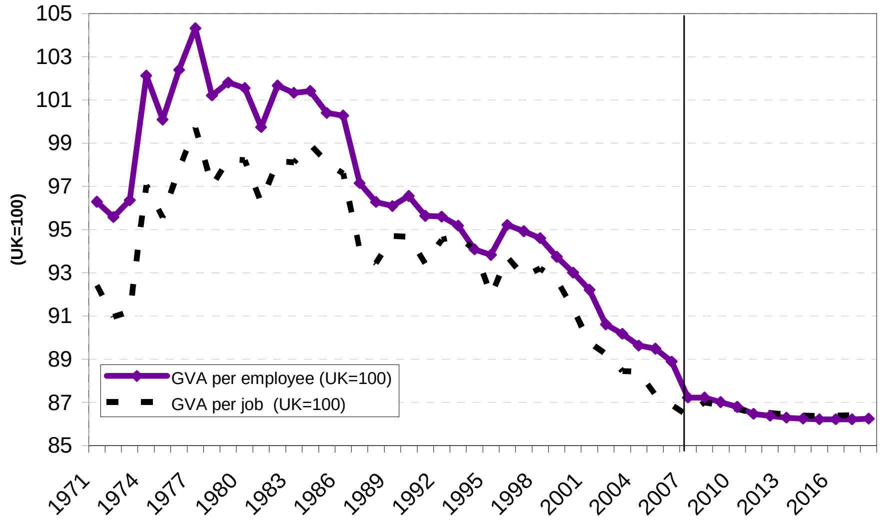


Source: Regional Accounts, ONS, Oxford Economics

GVA per employee

This indicator, a measure of productivity, lies behind the general lack of improvement in GVA per capita since we forecast no substantive improvement in relative productivity. This forecast is built upon the projected productivity in 26 individual sectors. These in turn depend on our current forecasts for expenditure on R&D, levels of enterprise, FDI flows and the skills base. Forecasts suggest that none of these is viewed as likely to improve sufficiently to have much influence on productivity levels. It is here where the challenges set out in the Programme for Government for 'closing the productivity gap' are most usefully set in context. Our baseline, which is policy neutral, suggests the status quo will not deliver any tangible improvement in relative productivity and an increase in this indicator will be a significant challenge to deliver upon. The forecast does however suggest a slowing in the trend decline in relative productivity. This is partly based on assumptions that well established trend declines in GVA per head in parts of the public sector will level off.

Figure ES.5: Goal: GVA per employee in Northern Ireland relative to the UK (UK=100)



Source: *ONS, DETI, Oxford Economics*
Note: *This indicator, as specified by EDF, divides GVA by employee levels. The self employed, though contributing to GVA, are not included in the denominator.*

As discussed in previous sectoral productivity research for DETI, the issue of low labour productivity (as defined by GVA per employed worker) is far from clearly understood. The data has limitations and figures for sectoral GVA are still only available on the consistent and agreed Regional Accounts basis up to 2005. Data deficiencies lead to questions about the extent to which the 'productivity gap' is accurately measured by official data. Looking at the sectoral picture in Table ES.2 there are a number of sectors with productivity differentials which appear hard to reconcile with known facts in relation to the sector in question. Further work is required to better understand the differentials as it appears strange that sectors such as retailing have not experienced some catch-up to UK average levels as national chains have moved in. It is also worth noting that manufacturing productivity is less than 5% below the UK average making it one of the better performing sectors In contrast financial and business relative productivity has fallen steadily further behind the UK average in recent years, partly a result of the impact of new call centres paying wages below the N|I average. It remains important that the sectoral picture underpinning the productivity forecasts is clearly understood – new data due in late 2008 will provide additional evidence allowing the current picture to be better quantified and it is not beyond possibility that this will depict considerable revision and thus adjust the current picture[2].

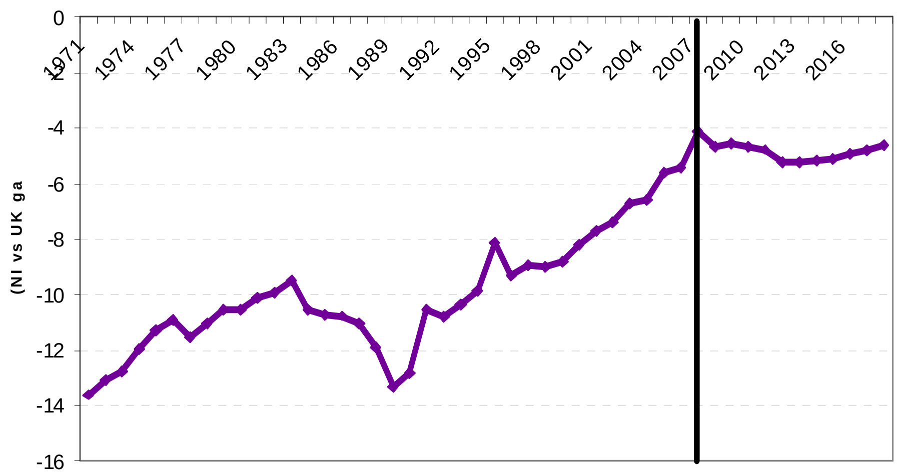
Table ES.2: Relative productivity, Northern Ireland, selected years (UK=100)

	1998	2003	2008
Agriculture	98.3	75.5	81.6
Extraction	74.1	108.2	124.5
Manufacturing	94.1	92.6	97.1
Utilities	100.5	124.0	119.3
Construction	96.6	86.5	84.9
Distribution & hotels	95.7	90.5	92.2
Transport & communications	91.9	91.4	84.7
Financial & business services	94.8	84.6	77.6
Public admin	124.9	114.5	121.9
Education & health	97.3	92.8	92.4
Other personal services	99.2	99.2	92.3
Total	93.2	88.5	87.0

Source: *Regional Accounts, DETI, ONS, Oxford Economics*
Note: *conditional formatting – red cells represents 10% below the UK average and blue 10% above the UK*
The figures are based on GVA per job (that is they include self employee jobs as well as employees)

Employment rate gap

Figure ES.6: Goal: Working age employment rate (NI vs. UK gap)



[2] In addition to further years data the new Regional Accounts data will incorporate revisions to the way the adjustment for financial services is handled by moving it into the sectors which avail of bank lending as opposed to a stand alone item – this is likely to have disproportionate effects on regional / sectors.

Source: *DETI, NOMIS, NISRA, ABI, Oxford Economics*
Note: *This is an LFS/APS definition of employment rate (that is people based and 4 quarter averages, save for 2007 which uses three quarter of 2007 and one of 2006).*

Northern Ireland's success in job creation in the recent past, beginning in early 1990s is clearly evident in Figure ES.6 with observable convergence in reported employment rates. The forecast is not for a continuation of this trend as job creation ceases in a number of key sectors. The end of strong job growth in construction and retailing is more marked than in the UK as a whole. In addition a projected short term slow down in professional services expansion particularly impacts upon this goal. Table ES.3 shows the extent of the slow down with job loss projected over the 2007/09 period compared to nearly 20,000 net jobs in the two years up to 2007.

The outlook for relative employment rate would be improved by a reduction in migration, but as our baseline forecasts depicted these are already substantively below the NISRA official outlooks already. Should migration stay at NISRA levels then employment rates would weaken further as job creation fails to keep pace. The end of the job creation boom would be even more marked under the more severe downturn scenarios so there is a downside risk that striking as it is, this may be an optimistic forecast of this goal (of course to counter this slightly the rest of the UK will be adversely affected by a weakening outlook and thus relativities may not noticeable weaken).

Table ES.3: Employment change (000's)

	2005-07 (000's)	2007-09 (000's)
Agriculture	-0.5	-0.2
Extraction	0.1	-0.1
Manufacturing	-0.6	-1.3
Utilities	0.1	0.1
Construction	4.4	-5.5
Distribution & hotels	5.6	-1.2
Transport & communications	1.1	-0.9
Financial & business services	6.3	3.1
Public admin	-1.2	-1.0
Education & health	5.1	2.3
Other personal services	0.7	1.9
Total	18.5	-3.1

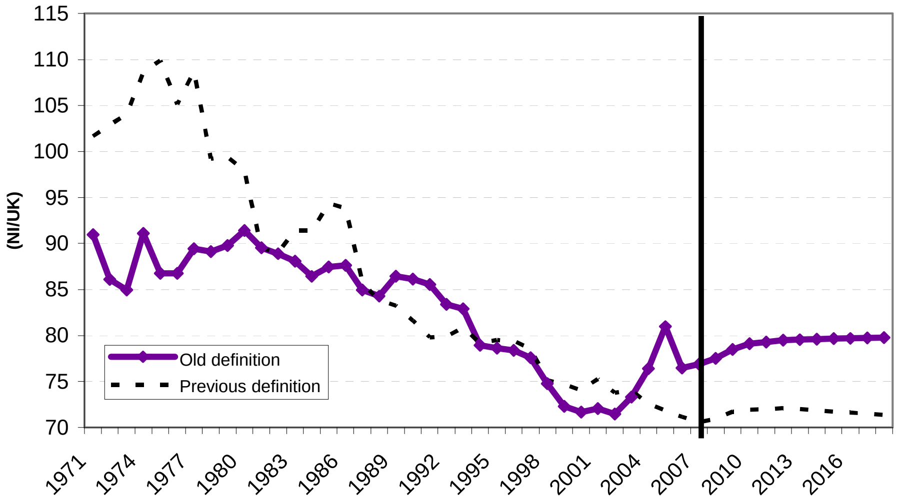
Source: DETI, Oxford Economics

Private Sector Average Earnings

The fourth EDF goal, average earnings[3] relative to the UK as a whole, is shown in figure ES.7. The forecast is for little change in relative wages as economic conditions prevent significant wage inflation and sectoral shifts are not large enough to lead to improve relative wage levels. The recent trends in relative wages reported in ASHE cannot be used to draw any conclusions due to data discontinuities, though the measure is notably above the corresponding Regional Accounts based measure. Despite this, the picture is similar to the GVA per capita measure in that the differential with the UK is in the order of 20%. The forecasts suggest the PfG target of attracting investment in sectors with above average wages will be important as the recent history is far from positive. However, wages in new inward investment projects will not help with convergence unless they are significantly above the existing NI average, and this may prove difficult to achieve.

[3] Average earnings are now measured using data from the ASHE data (previously it was ONS Regional Accounts data)

Figure ES.7: Goal: NI private sector earnings (NI/UK)



Source: ASHE, Regional Accounts, Oxford Economics

Note: Note for reference the previous ONS Regional Accounts data is depicted as a dotted line. Though the forecasts are different some individual data points show considerable divergence, particularly prior to 1980. Warnings in relation to the ASHE data point out that it cannot be used as a time series due to methodological changes, but the relative position in 2007 can be considered to be reliable. Notably the ASHE data records much higher relative earnings compared to the National Accounts measure.

As table ES.4 depicts, the wage differential with the UK average exists across much of the private sector and has improved only a little over the last 3 years. Data for the finance sector has weakened markedly, possibility as a result of call centres (though they should be classed in business services) and possibly due to fast growth in high paying jobs in London. Changes in survey methods are also a factor.

Table ES.4: Average earnings by sector, Northern Ireland relative to UK, selected years

	2004	2007
Agriculture	73.0	72.9
Extraction	65.4	56.7
Manufacturing	79.0	81.2
Utilities	107.5	112.6
Construction	77.5	78.2
Distribution	89.5	88.0
Hotels	90.4	89.6
Transport & comms	86.8	79.7
Financial services	80.2	69.1
Business services	72.1	74.3
Public admin	106.3	103.6
Education	103.2	103.5
Health	92.4	92.5
Other personal services	91.7	86.2
Total private sector	76.4	76.9
Total	87.5	86.7

Source: NES, ASHE, Oxford Economics

Note: red cells represent 10% below the UK average and blue 10% above the UK

Closing the gap – quantifying the challenge

By way of summary it is useful to quantify what might be required to achieve convergence in the EDF goals. Though it is beyond the remit of this project to develop a fully realised convergence scenario, it is useful to postulate in broad terms what form of alternate future would see improvement in the key metrics. To do this we have set out three stylised pictures of additional employment outcomes by 2018 and made assumptions about the sectoral make-up of these jobs, the productivity level, wages paid and proportion of jobs taken by migrants. This provides a useful set of ‘convergence metrics’ for which it would be possible to work back to the skills, FDI or R&D improvements that might be capable of facilitating or driving such an above trend performance.

Table ES.5: Scenario results: 2018

	Base	Scenario 1	Scenario 2	Scenario 3
Jobs (manufacturing)	-	15	15	15
Jobs (finance and business)	-	70	70	70
Productivty multipier	-	0.5	1	2
Proportion of new jobs taken by migrants	-	80%	0%	20%
GVA per person	81	83	92	102
GVA per employee	86	83	88	99
Employment rate	89	93	99	97
Average earnings in private sector	71	65	71	83

Source: Oxford Economics

Each of the scenarios assumes that 85,000 additional jobs are created over the next ten years. The majority of these are assumed to be in financial and business services, including call centres, but some are in manufacturing. In scenario 1 these new jobs are assumed to have levels of GVA per employee below the current NI average for each sector. In scenario 2 the productivity level is equal to the NI average and in scenario 3 it is above. Finally the scenarios differ in the extent to which jobs are assumed to be taken by migrants (in practice migrants may take jobs vacated by existing residents who move to the new jobs).

The table reveals the depth of the challenge facing the NI Executive and government departments to achieve significant ‘above trend’ performance in the EDF goals. With productivity at half the sectoral averages (scenario 1) 85,000 extra jobs would weaken both GVA per employee and average private sector earnings. Scenario 3, with 85,000 jobs at twice the sectoral average with 20% of jobs taken by migrants would achieve productivity convergence, though private sector wages would still remain close to 15% behind the average. Clearly such a figure – 8,500 extra jobs per year at twice sectoral averages of productivity – would involve a remarkable in-flow of FDI if we assume that only a limited growth of high value-added jobs can be generated with existing firms.

Summary – the golden age is over

In summary the macro economic conditions have taken a turn for the worse over the last 12 months and the ‘double whammy’ of the late 2007 / early 2008 credit crunch swiftly followed by rising inflation makes the short term outlook much less favourable than was the case when the last EDF forecasts were produced. Many of the difficulties will be felt right across the UK so there is only limited weakening of the forecast position for the goals expressed in relative terms compared to previous assessments. Oxford Economics base forecast is for slower growth in Northern Ireland but no outright recession unless macro-economic conditions weaken significantly over the next 6 months. The risks are clearly on the downside but at the time of writing the economy should avoid a recession. Even so a substantial rise in unemployment cannot be avoided.

The forecasts show little improvement in the key EDF goals of relative GVA per capita and relative GVA per employee. Indeed unless migration falls more sharply than we expect, GVA per capita may slip back further from current levels. The strong convergence in the relative employment rate seen over recent years is not expected to continue as the labour market stalls especially in construction and retailing, and as expansion slows in other service sectors. Equally, wage convergence towards the UK average appears unlikely. NI’s cost base remains an attraction for investors and a shift to higher wage investors in the current global climate appears difficult to achieve, at least in the short term.

The analysis suggests that in the current economic climate, the challenge of achieving a ‘step change’ in relative economic performance terms remains as great as ever. Nevertheless this lack of convergence in productivity over recent years should not blind us to the gains achieved. These include of a long period of strong labour market growth, a reversal of long term trends in net migration, a rapid escalation in personal wealth (though the house price correction will take this back significantly) and a generally strong economic climate. The more detailed report covering the complete baskets of goals, objectives and drivers of change provides a more in-depth set of performance metrics but by way of summary the economic challenges of a step change in performance and convergence with UK remains some way off and forecasts suggest that under policy neutral conditions this is likely to remain the case.

Oxford Economics
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