July 2017

Northern Ireland Economic Outlook

What comes next?...

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Highlights and key messages

Summary

The NI economy held up better than expected in 2016 but we expect a slowdown throughout 2017 as national and domestic political uncertainty continues.

The first half of 2017 has been a turbulent year for Northern Ireland (NI) on the political stage. The crisis around the Renewable Heating Incentive (RHI) scheme that emerged in late 2016 and the subsequent collapse of the NI Executive resulted in new Assembly elections in March. The subsequent talks intended to restore the Assembly institutions were pre-empted by Theresa May calling a General Election putting the NI talks on hold as voters headed to the polls, once again.

While local employment has returned to pre-crisis levels, NI's output, as at the end of 2016 remains 5.2% below its pre-crisis peak and is a restraint on recovery. Driving up productivity is the key to boosting output, improving wages and facilitating community cohesion – and the onus is on the private sector to deliver these gains as cuts to local government departments continue to cause difficulties in the public sector.

NI delivered gross value added (GVA) growth of 1.4% in 2016. This exceeds previous forecasts and reflects the resilience shown by the NI and wider UK economy in the wake of the EU referendum. However, this figure still falls below the growth rate for 2015 of 1.6%, representing a slowdown in economic growth. And, once again, NI remains the poorest performing region of the 12 UK regions in terms of GVA growth.

On a more positive note Purchasing Managing Index (PMI) data for NI in April showed the strongest rise in business activity so far for 2017 , though it did slow slightly to 53.5 in May. Job creation and export orders also grew strongly in May.

The PMI figures reflect the effect that a weak sterling has on the NI economy. Input prices continue to rise, though at slower rates than earlier in 2017, with manufacturing seeing the highest price rises; however, the retail sector and service sectors are also experiencing steady price rises.

May's figures also highlight the differences between the retail and manufacturing sectors. Output and new orders picked up for manufacturing firms but retail sector growth in sales and orders was at its weakest level since December 2015.

The rising costs that businesses are facing are also now feeding through to consumers as prices rise and real wages fail to keep pace. Across the UK, consumer spending is expected to be squeezed throughout 2017. We forecast that inflation will be 2.3% in 2017, with consumer spending slowing from the strong rates seen in previous years to 2.0% in 2017.

The latest trade figures for Q1 2017 show an increase in exports from NI- 12% up compared to 2016 with a weaker pound a significant contributing factor.

A combination of rising prices, inflation and a slowdown in employment growth is expected to impact upon consumer spending, a key driver of growth over the past year. Consequently, we expect NI growth of around 1.2% in 2017.

Brexit negotiations between the UK and EU have begun and there are serious implications for Northern Ireland, ranging from a potential 'hard border' to major risks to industries such as agri-food sector. Theresa May's commitment to maintaining the common travel area with the Republic of Ireland will be a priority in negotiations.

Our special article later in this outlook, takes a more detailed look at the potential issues facing the agri-food sector as a result of Brexit.

Despite publishing a Framework for the next Programme for Government (PfG), the NI Executive has not agreed a 2016-21 PfG. The consequences, should an Executive fail to emerge from the latest round of talks, are serious and will mean further constraints on public spending; no NI Budget; the unlikely delivery of lower Corporation Tax in 2018; and no coherent NI voice on Brexit.

The decision by the DUP to support a minority Conservative government under a "supply and confidence" arrangement is highly significant for the local economy. The deal gives N. Ireland £1bn of new money, including £400m for infrastructure, support for Health, Education, hi-speed Broadband and a "comprehensive and ambitious set" of city deals and a "limited number" of Enterprise Zones.

The UK government's recent *Industrial Strategy* consultation has implications for NI, with its *'10 pillars'* to stimulate skills, regional growth and investment. Following on from this, NI's Department for the Economy (DfE) launched *'Economy 2030'*, a consultation on *'5 pillars'* to transform NI into '*a globally competitive economy that works for everyone.'* However without a working Assembly, there can be no moves towards formalising and progressing an NI industrial strategy.

Brexit may well push NI towards focusing more on non-EU trading partners, PwC's latest "*World in 2050"* report suggests non-EU and emerging economies, particularly the E7, are set to become dominant global economic forces, eclipsing many EU members. It is therefore essential that NI seeks to build stronger relationships with the emerging economies in order to build long term growth.

In conclusion, a fully functioning and stable NI Assembly is vital to articulate the local case and to prepare the economy for changes and challenges that Brexit will result in. Anything short of 'fully functioning' institutions may become a political distraction from the vital task of addressing specific challenges facing NI post-Brexit.

Economic growth in NI, RoI and UK, 2015-2018

NI economic growth

1.6% in 2015

1.4% in 2016

1.0% projected for 2017

0.9% projected for 2018

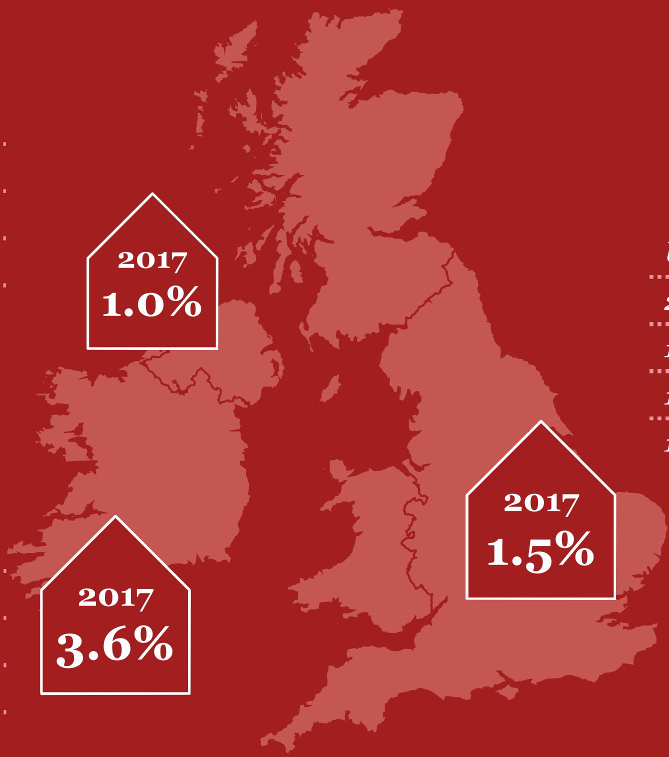
Republic of Ireland (RoI) economic growth

7.8% in 2015

4.0% in 2016

3.6% projected for 2017

3.2% projected for 2018



UK economic growth

2.2% in 2015

1.8% in 2016

1.5% projected for 2017

1.4% projected for 2018

Growth estimates and projections

GDP Growth (%)	2015	2016	2017	2018
NI	1.6%	1.4%	1.0%	0.9%
UK	2.2%	1.8%	1.5%	1.4%
ROI	7.8%	4.0%	3.6%	3.2%

Source: Office for National Statistics (ONS), Central Statistics Office (RoI), PwC (NI 2016-18, RoI 2016-18 and UK 2016-2018).

Key indicators

	2015	2016	2017	2018
UK consumer price: (Inflation annual average)	0.0%	0.7%	2.8%	2.9%
UK interest base rate (Q2 2017)	0.5%	0.25%	0.25%	0.5%
NI claimant count seasonally adjusted, (May 2017)	43,800	37,300	31,200	32,000

Source: ONS, NISRA, Nomis, PwC (inflation 2017 and 2018, claimant count 2017 and 2018 and interest rate 2017 and 2018).

NI Recovery Dashboard – June 2017 update

Economic commentary understandably tends to focus on the short-term - "how much will output in the NI economy grow this year or next year?" or "what's the prognosis for inflation/property prices / unemployment?"

However, given that the NI economy has been growing, albeit slowly, for about three years, it is also worth asking how much ground has been made up over the longer term. If the region's peak economic performance occurred just before the banking crisis and housing market slump, which began in mid 2007, just how much of the lost ground has the economy clawed back?

In order to measure this, we have looked at a range of indicators, to define and measure the Northern Ireland Recovery Dashboard. These indicators are:

- The Northern Ireland Composite Economic Index (NICEI), which is an index measure of the performance of the NI economy produced by the Department for the Economy (DfE);
- Real disposable household income
- Employment rate, based on the Labour Force Survey (LFS)
- Employment in key sectors, based on the Quarterly Employment Survey
- Unemployment as measured by the claimant count
- House price affordability

For each indicator in our dashboard we looked at the point in time when it peaked, assigned an index value of 100 to that value, and compared the current measure of that indicator, again on an index basis, against the peak value. The exact time when each indicator peaked varies but in most cases the indicators point to either 2007 or 2008 as representing the previous peak in the NI economy. In summary, these recovery measures show if the NI economy has reached its pre-crisis levels or how much further it still has to climb. An upward green arrow specifies improvement relative to the previous NIEO estimate (November 2016), yellow indicates that the indicator has not changed since the last NIEO and a red downward arrow specifies a decline in the indicator since the last NIEO estimate.

	Current value	Recovery measure value (pre -crisis peak = 100)	Recovery measure movement since last NIEO
NICEI – index value[1]	105.3 (Q4 2016)	94.8	↑ by 2.1
Real wages (Gross Weekly Earnings – at 2005 prices)	£304.2 (Apr 2016)	94.4	↑ by 1.6
Real disposable household income (at 2005 prices)	£14,645 (2014)	89.0	no change
Housing market affordability (house prices/earnings)[3]	5.58 (Q1 2017)	115.3	↑ by 6.5
Employment rate (Labour Force Survey	68.8% (Feb-Apr 2017)	99.2	↓ by 0.3

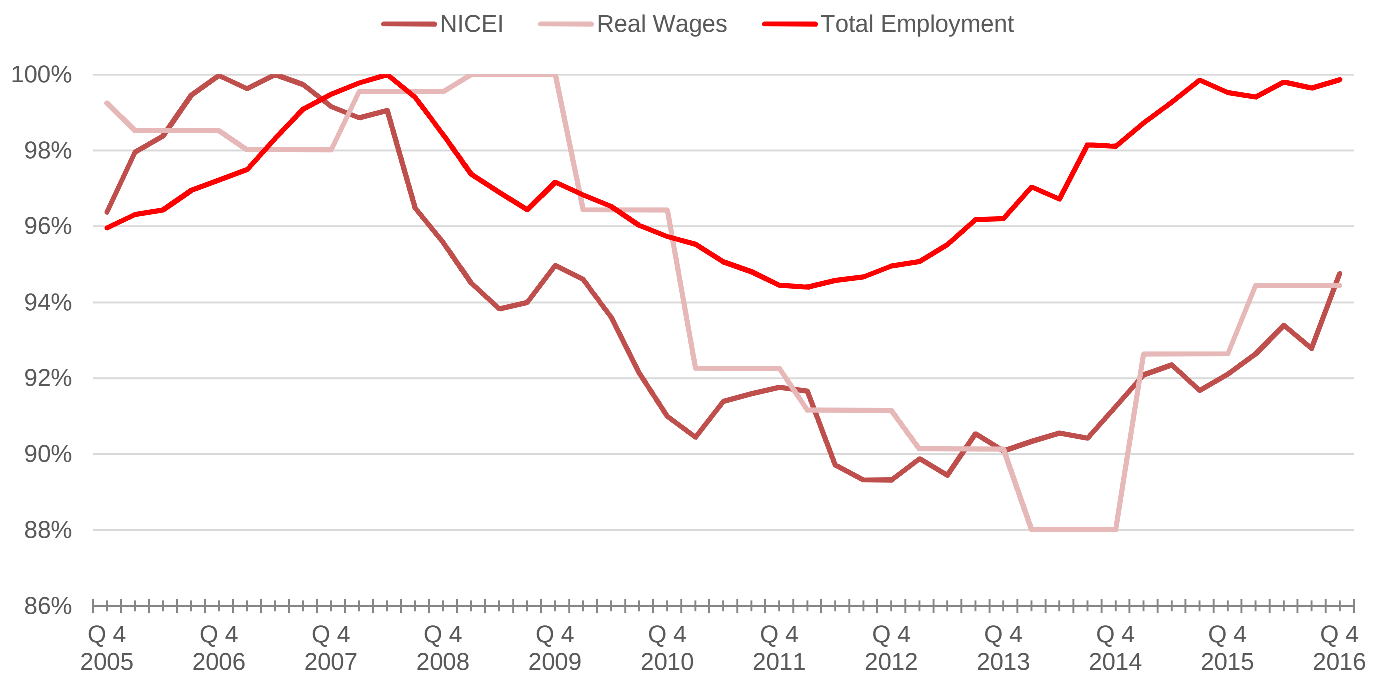
	Current value	Recovery measure value (pre -crisis peak = 100)	Recovery measure movement since last NIEO
Employment[2] - all sectors	745,580 (Mar 17)	101.7	↑ by 1.4
Employment[2] - construction	30,020 (Mar 17)	68.4	↑ By 4.1
Employment[2] - manufacturing	81,890 (Mar 17)	96.5	↑ By 1.4
Employment[2] - services	609,050 (Mar 17)	104.2	↑ by 1.2
Unemployment rate (Claimant count)	3.5% (May 17)	74.3	↑ by 9.3

[1] *The NICEI is an index value where 100 equates to the value of the base year, 2013. Any values above 100 show growth over the base year value and values under 100 show a decline over the base year value.*

[2] *The employment figures listed here are taken from the Quarterly Employment Survey (QES). The figures provided here are the number of employee jobs and are seasonally adjusted. It should be noted that the survey counts the number of jobs rather than the number of persons with jobs, e.g. a person holding a full-time job and part-time job will be counted twice.*

[3] *Our measure of housing market affordability is calculated by using the NISRA Median House Price value and nominal earnings data taken from the Annual Survey of Hours and Earnings (ASHE). The lower the value, the more affordable housing is.*

NI Recovery measures: 100%= pre-crisis level



The most recent economic indicators in our NI Recovery Dashboard suggest that the NI economy is steadily moving closer to its pre-crisis peaks. However, some indicators (unemployment rate & construction employment) still remain well below their peak and a return to their previous levels appears to be only feasible in the long term.

The latest NICEI results showed that NI economic activity increased by 2% in real terms between Q3 2016 and Q4 2016, a larger increase compared to the 0.5% increase between Q3 2015 and Q4 2015.The Q4 2016 NICEI result is 2.7% higher in real terms than the level in Q4 2015.

The NICEI value in Q4 2016 remains 5.2% below the pre crisis peak, which suggests that there is still plenty of room for more growth.

Real wages grew by 1.8% between 2015 and 2016 - a slowdown compared to the 4.8% growth rate seen in real wages between 2014 and 2015. Of further concern is the fact that NI workers' real wages in 2016 are around £930 per annum less than in 2009.

Employment has all but recovered to pre crisis levels. The LFS employment rate reached 68.8% for the three month rolling average covering Feb-Apr 2017, which is just below pre crisis levels. Notably, the claimant count fell for the fourteenth month in a row in May, dropping by 7,300 between March 2016 and May 2017.

Total employment, as measured by the Quarterly Employment Survey (QES), reached 745,580 in March 2017, 101.7% of the pre-crisis peak. Notably manufacturing jobs have increased between end of 2016 and the first quarter of 2017. Manufacturing employment now stands at nearly 82,000, its second highest rate since the crisis.

Employment in services meanwhile has decreased by almost 2,000 over the past quarter with construction employment rising by under 1,000 jobs.

These employment figures suggest that the NI jobs recovery has slowed over the past six months and that we may be reaching a plateau at employment levels similar to the pre-crisis peak levels.

It is apparent therefore, that job creation is not being accompanied by a proportionate increase in wealth-creation. Further economic recovery will therefore rely on an increase in productivity, and knock-on increases in real wages and household incomes. To continue and measure NI's economic recovery only by employment levels, would be misleading.

2017 will be a testing year for economic growth in NI, as the impact on business investment and uncertainty due to Brexit may start to be felt, particularly in industries with a focus on EU trade, such as manufacturing and agriculture.

Whatever political situation emerges in 2017, both business and government need to work together to address the issues of low productivity and low wages to ensure that the NI recovery keeps moving. And with a forecast of 0.9% economic growth for 2017, that improvement is urgently needed.

A new world for agri-food in NI?

The implications of Brexit will be felt across all sectors of the NI economy. In this article we highlight possible implications of Brexit for the agri-food sector in particular and look at the potential issues and options that the sector will face in a post-Brexit world…

What role does the agri-food sector play in the NI economy?

The NI agri-food sector makes up a relatively small proportion of the overall NI economy – accounting for around 3.2% of GVA in 2015. However, when compared with the UK agri-food sector, it makes a larger contribution in relative terms – Box 1 outlines some key numbers in this respect.

Box 1: Agri-food and the NI economy

5.5% of people in NI were employed in the agri-food sector compared to **2.4% in the UK as a whole in 2015.** [1] (DAERA, 2016)

The agri-food sector accounts for around **75,000 local jobs** made up of c 50,000 farmers and workers and c25,000 food and drink processing workers. [2] (NI Assembly, 2016)

The NI agri-food sector generated GVA of **£1.1bn (3.2% of NI's GVA)** compared to only **2.3% in the UK in 2015.**[1] (DAERA, 2016)

Has the vote to leave the EU had an impact yet?

In the short term, the impact of the referendum has been broadly positive for the NI agri-food sector. The sector has seen some significant benefits due to the devaluation of the pound against the Euro with the dual benefit of cheaper exports and the increased value of Euro-dominated subsidies such as the Single Farm Payment.

NI farm gate prices are estimated to have risen some 53% between July 2016 (lowest point) and December 2016 (highest point). While this is welcome news, there are still concerns due to high costs for production and the extent of debt incurred during previous periods when there has been a depression in prices.

Therefore this current rise in prices is predicted to be only a short-term benefit and is not predicted to continue in the long term.

What EU funding does the sector currently receive?

Currently farmers in NI receive significant funding from the EU, mainly in the form of payments made from the Common Agricultural Policy (CAP). Box 2 outlines the funding across the two pillars of the CAP that NI farmers will receive over the 2014-2020 period. Between 2005 and 2014 the CAP Single Farm Payment alone totalled £2.5billion in Northern Ireland in payments to NI farmers.

A significantly higher proportion of annual farm income comes from CAP payments - 87% for NI farmers – when compared to farmers in the rest of the UK – 53% of annual farm income for the UK as a whole.

What are the key issues that the sector needs to address?

Box 3 outlines the 4 key issues that we believe must be addressed in order to safeguard the future success of the NI agri-food sector. In order to develop innovative and forward looking responses to these issues, all stakeholders in the agri-food sector – including the the NI and UK governments - will need to work closely together.

Box 2: CAP funding to NI farmers

Common Agricultural Policy

Direct Payments (Pillar I)	Rural Development Programme (Pillar II)
€2,229m over 2014- 2020	**€228m** over 2014- 2020

36,707 beneficiaries in Northern Ireland in 2013/14

Box 3: Key issues for the agri-food sector post-Brexit

Direct funding for farmers	*The future of direct CAP payments post-2020 is unknown. The reliance on direct farm subsidies has created inefficiencies which need to be addressed in a post-Brexit world. To do so will require some form of reform/transformation of the sector.*
Support for rural development	*Other funding programmes including Rural Development Programme and funding for R&D e.g. Horizon 2020 are likely to be impacted. This could present challenges for wider R&D programmes which support the future development and innovation of the sector as a whole.*
Risk of trade barriers	*The proximity of the RoI land border could present massive problems as there is significant movement of agri produce across the Irish Border and the possibility of tariffs is very high.*
Access to skilled labour	*Ability of non-UK citizens to come to NI to work could be restricted or abolished which could have implications for NI processers reliant on the labour of non-UK citizens.*

What are the options for a post-Brexit funding model?

Responding to the impact of Brexit is an opportunity for reform in the agri-food sector and in this regard we believe that there are several possible options:

- The first option is the "*no subsidy*" option, that is simply accept the loss of the EU funding and offer no replacement. The sector will be fully exposed to free market conditions;
- The second option is *"replicate EU funding"* where the UK and NI governments replicate the EU funding through existing or new mechanisms, ensuring continuity and financial security for farmers but with a continued reliance on direct payment subsidies; and
- The third option *is "reform with re-tailored subsidies"*. This would involve some type of reform of the agri-food sector and its funding structures (much like the policies adopted in New Zealand, Canada and Australia) with subsidies tailored more towards the specific needs of the sector but with more exposure to free market conditions.

Box 4 overleaf takes a look at two countries that NI could look to when considering possible future subsidy options for the agri-food sector.

What are the next steps for the sector?

Globally the trend with regards to agricultural subsidies is towards reducing subsidies to farmers, removing trade barriers and encouraging farmers to be more export focused. Even within the EU, CAP payments have been decreasing as a share of the EU's budget greatly since the 1980's peak, the EU spends 39% of its budget on the CAP now, down from 70% and this percentage is expected to decrease further after 2020.

While it may still be a number of years before the UK formally leaves the EU, work must begin now to consider how best to respond to the issues that currently exist in the sector, so that it is in the best position possible to respond to the challenges that lie ahead and the impacts of future changes.

It is clear, given the current reliance of the NI agri-food sector on direct subsidies, that it will need a package of support from the NI and UK governments to enable it to transition successfully to the post-Brexit world. There are a range of examples and lessons from other nations that have been through such transitions in their agri-food sectors previously that NI should look towards as examples and apply where possible the learnings and lessons from those nations.

Box 4: Lessons from around the world

New Zealand (NZ)

The NZ government heavily increased subsidies to farmers in the 1970s to respond to changing international market conditions. This contributed to a high budget deficit, which led to high inflation in the NZ economy. It also led to environmental degradation, low productivity and no incentive for farmers to innovate.

A new government in the 1980s discontinued agricultural subsidy programmes as part of a larger package of economic restructuring and reform. This included the scaling back of tariffs on imported inputs. As a result:

- Around 1% of farmers were forced out of business
- Sheep farmers were the most heavily subsidised and therefore the hardest hit
- Farmers with high debt suffered from rising interest rates
- Farm income was markedly reduced in the period immediately after the reforms were introduced, but recovered and began rising after around seven years.

Currently, producer support in NZ is among the lowest of OECD countries and overall agricultural policy is market-oriented, with a heavy emphasis on exports. The sector is reliant on open trade and low tariffs on imported inputs. NZ is a net exporter of agricultural products: more than 50% of its exports coming from the agri-food sector and it is the world's largest exporter of sheep and dairy products.

Some funding still exists within the agri-food sector in NZ and includes:

- Income support in the event of natural disasters;
- Support for public goods: national frameworks for land and water quality and allocation have been established to enhance the sustainable management of biological and natural resources; and
- Levies: many activities such as market research and development, quality assurance, and plant and animal health protection are funded by producer levies.

Overall, the reforms of the 1980s forced farmers to consider the choice of enterprise, input levels and capital investment and has resulted in high levels of productivity in the sector.

Switzerland

Whereas New Zealand (and other nations such as Canada and Australia) have moved away from direct payments to farming models, Switzerland has maintained high levels of direct support – 55% of gross farm receipts in 2014 came from some form of taxpayer subsidy and agriculture in Switzerland is one of the most protected in the world.

Reforms in the 1990s introduced a new system of direct payments which were not based on production levels, instead the reforms put heavy emphasis on environmental issues and innovation and payments became related to biodiversity, landscape quality and farming practices. Since 1999, all direct payments to farms have been based on stringent proof of ecological performance.

Although the high subsidies help to ensure the subsistence of the small-scale agricultural structure in Switzerland (average farms size in 2014 was 23 hectares compared to 40 hectares in NI in 2015 and 248 in New Zealand) many commentators view the subsidies as still preventing innovation in Swiss farms and maintaining an uncompetitive farming structure.

A recent WTO review in 2017 noted concerns from both the EU and the US about the levels of protectionism in the Swiss agriculture sector. Recent moves have been made to make further reforms, currently, Switzerland's agricultural policy for the period 2014-2017 is working to improve again the efficiency of direct subsidies, while their elimination could be possible by 2020 according to the Swiss State Secretariat for Economic Affairs.

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