Could uncertainty be your best opportunity?

Economic Eye
Summer Forecast 2017

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Latest forecast overview

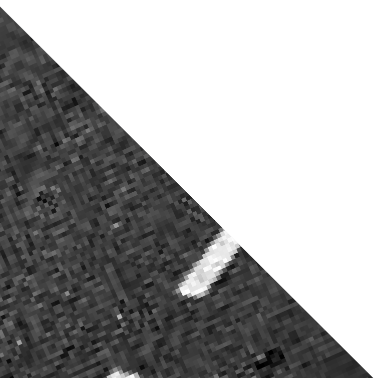
The previous EY Economic Eye, released in December 2016, referenced being published in what was felt to be the most uncertain economic climate in decades. Since then, it is difficult to comprehend that 2017 has already delivered two elections in Northern Ireland (NI) and that NI remains without an Executive. In the Republic of Ireland (ROI), 2017 has been relatively calmer, yet the country has just started a transition from Taoiseach Kenny to Taoiseach Varadkar which will no doubt present further change for the country.

In recent months, sentiment on the tone and outcome of the upcoming Brexit negotiations was coalescing around a hard Brexit. Since the UK general election, that direction seems less certain. Although Brexit out-workings will remain unclear for some time, there are examples of where Brexit related impacts are already being acutely felt, with shifts in inflation rates and exchange rate fluctuations being clear examples.

Amidst all the headline uncertainty, there are some contextual positives to draw on. For example, the IMF cites an upturn in global economic activity with increases in investment, manufacturing and trade all expected to drive global economic growth from 3.1% in 2016 to 3.5% in 2017 and 3.6% in 2018.

Cutting through all the noise created by elections and Brexit uncertainty reveals an island economy that does continue to grow. In 2017, total employment is expected to add 29,000 onto 2016's figure with both NI and ROI expected to post increased job numbers. Beyond 2017, economic performance in NI and ROI diverges. By 2020, forecasts for NI suggest a decline of just 3,500 jobs from the 2016 position, with the largest declines expected in manufacturing and the public sector. In ROI, employment is forecast to be c.91,000 more in 2020 than 2016 with construction, retail and the health sector driving much of this growth.

This Economic Eye forecasts a tougher period ahead than in previous editions but the time ahead is not without opportunity amongst the challenges. Both jurisdictions have made progress in maintaining and improving competitiveness since the downturn. Firms have a role to play in all island economic competitiveness. Firms and policy makers need to be on the front foot, assessing new opportunities to enhance capacity and competitiveness, assess Brexit exposure and develop contingency plans around talent, tax, trade, tariffs and logistics. Pace is crucial as the landscape changes.



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Policy update

Brexit dominates but fundamentals of competitiveness need continued policy focus

Prior to the most recent series of election fever the economy across the island was beginning to consider the emerging themes of inflation, consumer sentiment, currency fluctuations and changing trends in FDI flows. Inward investment across the island remains buoyant. How this inward investment story unfolds over the next 2-3 years will have an important bearing on the island's economic fortunes.

Brexit uncertainty did lead to a stronger Euro against Sterling – an outcome that has boosted NI exports, and hotel occupancy from cross border visitors but conversely has delivered a sharp decline in UK visitors to ROI and applies pressure to ROI exporters selling into the UK. On a positive note, continued strong domestic demand has maintained momentum in the broader ROI economy.

As a result, forecasts for the island economy, both in terms of GDP and employment growth, are slightly weaker over the medium term than in the last edition of Economic Eye as Brexit and associated currency impacts dampen our view of how consumer expenditure and ROI export performance will evolve by 2020. We expect GDP growth to average 2.4% per annum until the end of the decade.

Figure 1

All-island economic growth and employment performance (% annual growth)

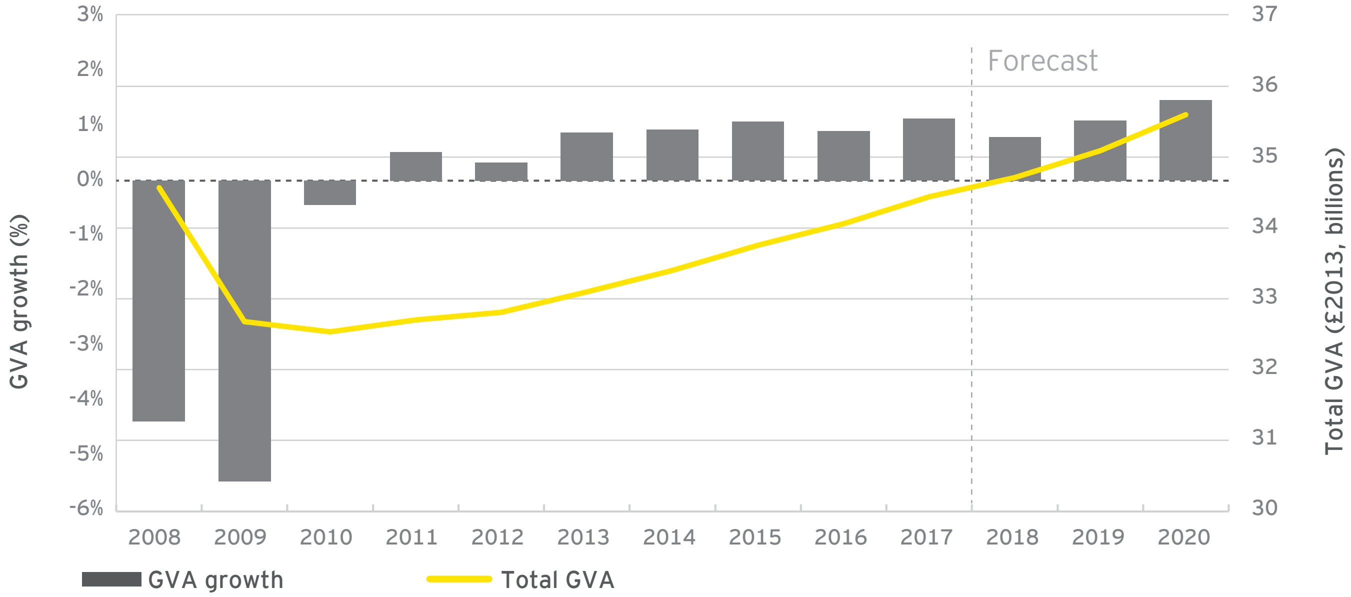
	All-island performance (annual percentage change unless otherwise specified)									
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Economic growth	0.0%	-0.9%	1.0%	7.3%	22.6%	3.7%	2.4%	2.3%	2.4%	2.5%
Employment	-1.2%	-1.1%	2.4%	1.8%	2.2%	2.2%	1.0%	0.4%	0.5%	1.1%

Sources: Oxford Economics, ONS, CSO

The two economies on the island have significant structural differences, with ROI relying more on trade and NI on consumer and government spending. Inflationary pressures and an ongoing tight public spending environment in NI result in a slower growth forecast in NI. We expect GDP growth of 1.1% for 2017 to be followed in 2018 by growth of just 0.8% in NI. The pace of growth does recover late in the decade with 1.4% growth forecast for 2020. By 2020, the forecast suggests that GDP will not yet have recovered the losses of 2007's peak, placing NI well into a second decade of recovery.

Figure 2

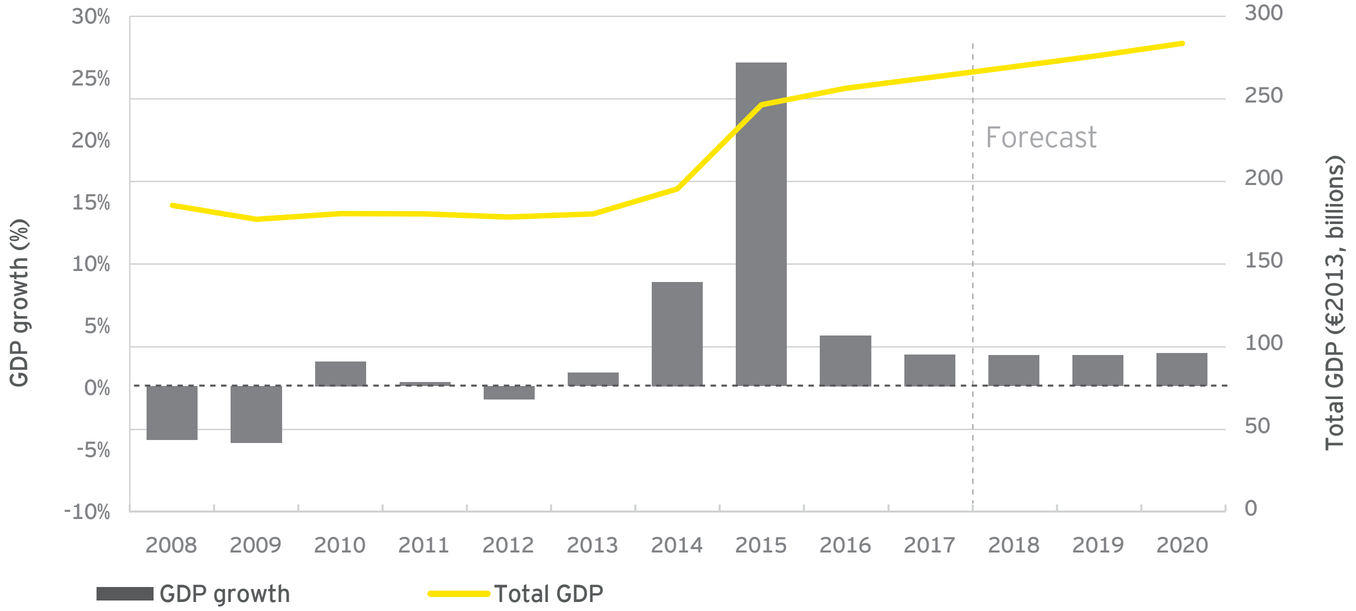
NI GVA growth forecast (£2013, billions and % annual growth)



Source: Oxford Economics

Figure 3

ROI GDP growth forecast (€2013, billions and % annual growth)



Source: Oxford Economics

Growth in ROI is expected to continue at a reasonable pace, compared to NI and the UK, buoyed by consumer spending which buffers against a slowing pace of growth in the government sector. Between now and the end of the decade, growth in the ROI is expected to average 2.7% per annum.

While the national discourse has centred on the 'unknowns' of Brexit, business and the wider economy have been dealing with some of its effects already, through inflationary pressures and currency fluctuations. In the 12 months since the UK vote to leave the EU, Sterling is over 10% weaker against the Euro and consumer prices are beginning to rise. While consumer sentiment across the island has held up well over the past 12 months, new car registrations – often a bell weather of economic fortunes – have declined by nearly 1,000 over the past 12 months.

Figure 4

ROI employment change

Employment Change					
	May 2016	Aug 2016	Nov 2016	Feb 2017	May 2017
GBP/Eur exchange rate	1.30	1.17	1.18	1.17	1.14
ROI Consumer Price Index (% annual change)	0.0%	-0.1%	-0.1%	0.5%	0.2%
UK Consumer Price Index (% annual change)	0.3%	0.6%	1.2%	2.3%	2.7%
New Car Registrations	11,065	-	-	-	10,127

Source: CSO, ONS, SMMT/SIMI

Other issues beyond Brexit

It is well recognised that we have a highly educated population, with average attainment levels well above the OECD average. However, much needs to be done to reform the Irish education system to support entrepreneurship and new ways of working, driven by global reach and the data revolution.

Talent will no longer be sourced only from local markets and there will be a global war for talent. Irish organisations may need to expand global footprint at a fast pace. Significant attention must be given to talent management and internal organisation structures being sufficiently agile to deploy the right people to the right places at the right cost and time. Care must be taken in each jurisdiction to ensure regulatory, tax, legal and HR issues are adhered to.

Ireland's corporate tax regime has long been a driver in attracting inward investment and facilitating job growth. However, with a marginal tax rate that continues to be one of the highest in the OECD, Ireland's personal tax regime is uncompetitive and inhibits job creation. Businesses establishing themselves overseas will invariably rely on expatriate employees while they look to gain a foothold. It is therefore important that key decision makers are not put off by a costly personal tax regime. Whilst Ireland's 'Special Assignee Relief Program' goes some way to reduce the personal tax burden for individuals on very high remuneration, it falls short of competitor expatriate regimes when lower salary levels are compared.

Separate to this, much more needs to be done to reward and incentivise entrepreneurship in recognition of its contribution to job growth and the wider economy. If the new Government is serious about delivering full employment by 2019, it needs to make changes to the personal tax regime to aid job creation, including reducing the marginal tax rate to a competitive level, reducing the rate of capital gains tax, and providing incentives to reward entrepreneurship and attract key talent to Ireland.

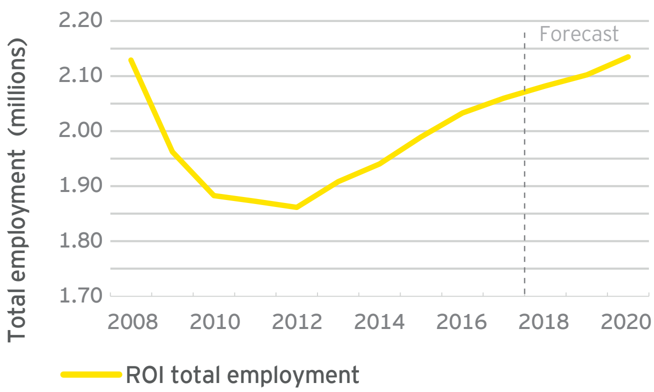
Whilst appreciating positive reductions in personal tax rates, income and capital gains taxes, cannot happen overnight, a roadmap and clear understanding of when the rates will reduce would be very positive.

Job performance typically garners more attention than GDP growth in policy design and policy ambition. For example, incoming Taoiseach Varadkar aims to deliver full employment – a job for everyone that wants one – by 2019. In addition, there is an increasing policy drive across the island to improve the quality of employment with more references to 'good' jobs emerging from strategy papers. A range of issues that go beyond the forthcoming Brexit outcomes add to the complexity of forecasting. Technological advances are seeing increased levels of automation emerge in manufacturing, retail trends continue towards online, forcing a rethink in how retail districts retain relevance and vibrancy. Added to this, new sectors are emerging across the island (e.g. cyber security in Belfast) and inward investment levels are remaining buoyant.

2016 was a good year for employment statistics across the island. ROI added 57,000 and NI added 6,000 jobs. By 2020, while perhaps not full employment, there are an additional 91,000 forecast for ROI between 2016 and 2020.

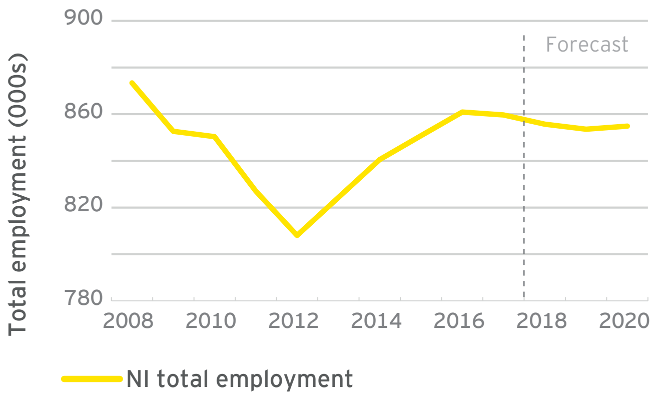
NI does not fare as well as ROI on jobs. Although neither labour market has surpassed 2007 peaks, ROI has been on a consistent growth trajectory that shows little sign of abating. NI, on the other hand, is forecast to grow modestly in 2017 but then shed 3,500 jobs by 2020. The first quarter data for NI points the very real possibility of a fall in total employment beginning this year rather than, as forecast, in 2018.

Figure 5



Source: Oxford Economics

Figure 6



Source: Oxford Economics

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Ireland's North and South contrast

Sector employment performance reveals an island economy heading in different directions. The impressive gains in job numbers across the island since 2012 are expected to slow. In NI, the expectation is for a decline of 3,500 by 2020, having added over 50,000 jobs since 2012. The drivers of recent NI job gains are expected to falter, particularly in manufacturing where close to 4,000 jobs are forecast to be lost by 2020.

Figure 7

ROI employment change

Employment Change	2012-2016	2016-2020
Agriculture	27.3	-12.8
Mining and quarrying	-2.0	-0.2
Manufacturing	21.6	-2.8
Electricity, gas and water	2.2	-0.1
Construction	33.3	18.5
Wholesale and retail	16.4	19.4
Accommodation and food	26.5	4.4
Transport and storage	5.0	4.6
Information and communication	5.6	9.9
Financial and insurance	-3.6	5.1
Real estate	3.7	0.5
Professional, scientific and technical	19.0	10.9
Administrative and support	5.4	10.6
Public administration and defence	2.8	0.4
Education	7.4	6.0
Health and social work	9.0	10.1
Arts and entertainment	1.6	2.1
Other services	3.9	4.2
Total	**185.1**	**90.8**

Source: Oxford Economics

Figure 8

NI employment change

Employment Change	2012-2016	2016-2020
Agriculture	4.8	0.0
Mining and quarrying	0.0	-0.2
Manufacturing	9.0	-3.7
Electricity, gas and water	1.2	-0.3
Construction	-1.3	0.4
Wholesale and retail	3.0	-1.4
Accommodation and food	0.1	0.1
Transport and storage	3.3	0.1
Information and communication	3.6	0.8
Financial and insurance	-0.6	-0.6
Real estate	0.3	0.2
Professional, scientific and technical	6.0	1.2
Administrative and support	10.5	2.8
Public administration and defence	-6.4	-4.0
Education	-0.6	-1.1
Health and social work	11.4	0.6
Arts and entertainment	1.8	0.7
Other services	4.7	1.0
Total	**50.8**	**-3.4**

Source: Oxford Economics

In ROI, key sectoral drivers to 2020 include retail and construction. Between them, these sectors could account for close to half of net new jobs. There is a further potential upside risk to the construction projections, should new Taoiseach Varadkar's plan to invest in additional capital spending above what is already planned through a new 10-year National Development Plan start to flow. The new investment would be intended to bring forward projects such as the Dublin Metro, the M20 between Cork and Limerick as well as investment in health and education buildings. This potential additional public investment outlines the different cycles across the island economy with NI facing a further tightening of public sector budgets and ROI finding room to deliver additional investment.

Not only are employment forecasts showing a divergent island economy, there are major sectoral and structural differences across the island with clustering of some sectors in discreet geographic regions. This divergence has particular relevance in the Brexit context as the changes to trade rules and regulations will impact parts of the island to differing degrees.

Two sectors which best illustrate the structural divergence across the whole island are agriculture and professional services. The agriculture/agri food sector is arguably the sector that is most developed as an all island sector with all island processing and deeply embedded supply chains. The map across shows that its influence cuts right across the island, with a particular concentration in the central belt and west coast regions. The UK market offers a highly significant market for Ireland's agri products. Trade statistics for 2016 from the Central Statistics Office cite that €3,281mn of agricultural exports go from ROI to the UK. This represents 48% of ROI's agricultural exports. Given the extent of this reliance on the UK market it is clear why policy makers are increasingly vexed by the terms of trade that will emerge post Brexit and how CAP payments will be impacted once the UK leaves.

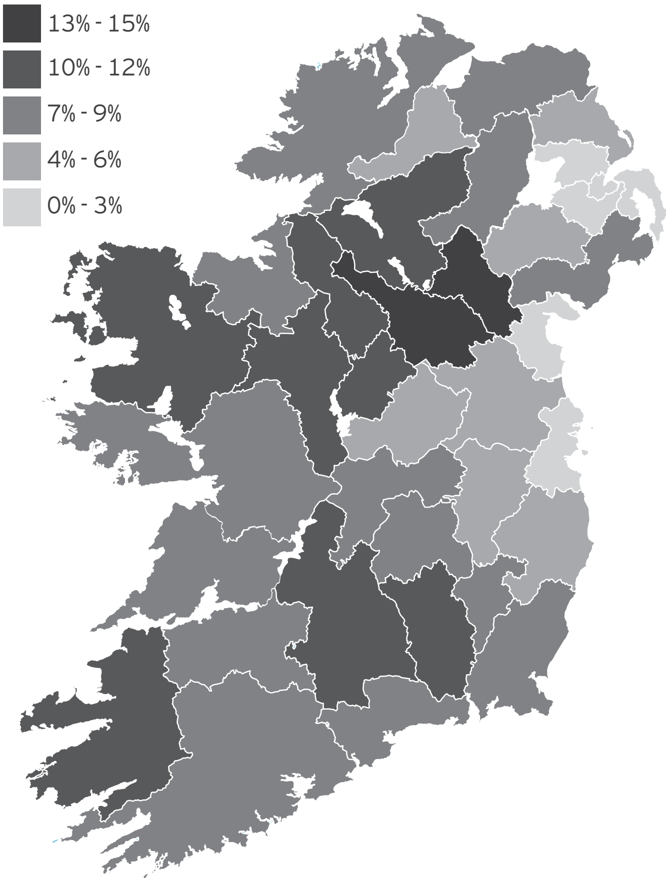
The map of professional services employment concentrations shows a sector that is tending to cluster around an east coast corridor centred on Dublin and Belfast and raises new questions around capacity constraints. The clustering effect of this typically high paying sector has been welcomed over recent years, indeed it has been a strong selling point to new inward investors. The extent of this concentration does raise challenges in relation to skills availability and living costs in the island's cities.

As such, there is an increasing recognition that regionally balanced growth is a desirable policy objective. Policy makers are facing into an emerging conundrum which must balance the benefits of developing centres of excellence in sectors, spreading sectoral growth across regions yet trying to ensure that cities, the engines of economic growth, are not choked off.

The forthcoming 'Ireland 2040 – Our Plan' National Planning Framework will be key to striking a balance between city, urban and rural growth across ROI. Regional cities may be well served by forming a collaborative network, similar to the Core Cities initiative in the UK, to drive forward common agendas.

Agriculture employment

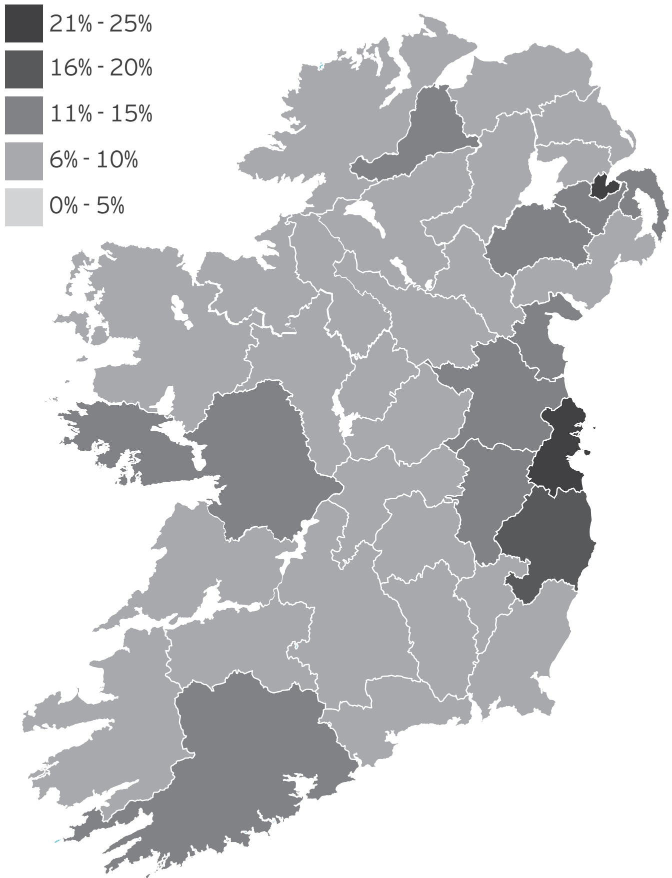
Employment as % share of total (ROI counties, NI Local Government Districts)



Source: CSO, NISRA, Ulster University

Professional services employment

Employment as % share of total (ROI counties, NI Local Government Districts)



Source: CSO, NISRA, Ulster University

Ireland's competitiveness

Policy makers across the island have reiterated the importance of enhancing competitiveness in the current economic and political climate. Certainly, an island economy that aims to deliver full employment in ROI and a clear rebalancing of the economy away from the public sector in NI must attract and grow businesses. The National Competitiveness Council in ROI has recently benchmarked ROI's competitiveness against the UK and, as a result, recognises a need for policy to focus on Ireland's macroeconomic environment as well as structural factors such as innovation capacity, the quality of infrastructure, costs of doing business and productivity across all economic sectors.

ROI has recently been judged by the IMD business school in Switzerland to be the 6th most competitive global economy, topping the rankings against 62 other countries when it came to business productivity and efficiency. For the first time, the international competitiveness rankings included a metric on digital competitiveness. ROI ranked 21st in this, reflecting relatively poor levels of broadband in non-urban areas. Maintaining or improving competitiveness will be crucial to continued economic success and the weakness in digital should serve as a timely call to action to enhance a world class digital infrastructure across the island.

In NI, research from Ulster University suggests that NI competitiveness has improved slightly over the past 5 years but challenges remain. NI's business environment and quality of life are its most competitive elements with productivity, employment and labour supply scoring lowest. With policies such as NI's Industrial Strategy, Employability Action Plan and Programme for Government stuck in cold storage while there is no Executive, the ability to improve competitiveness is hindered somewhat, a situation that places an increasing drag on economic prospects, the longer it goes unresolved.

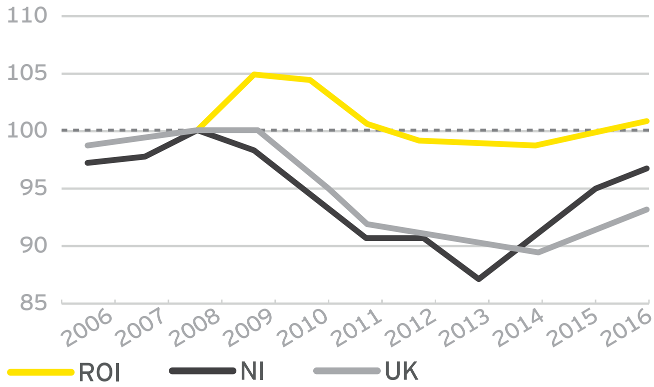
Wages and inflation

During the global crash there was a strong case made across the UK and Ireland that exceptionally difficult spending decisions had to be made 'in the national interest' and that we were 'all in it together'. While it could never be claimed that austerity was welcomed or unanimously supported, this narrative delivered a period of public spending restraint and, for many, real terms wage declines. The issue is more acute in NI, where wage levels are lower than they were a decade ago. A very benign inflationary environment, and the return of an easier credit environment during this period went some way to offsetting the absence of pay increases.

Over the past 12 months, wage levels have become a prominent issue across the economy. That reluctant acceptance of low/no pay rises (and in the case of ROI tax rises) during the immediate post-recession period is fading. Increasing demands for public services as waiting lists increase or police numbers fall, coupled with food and forecourt inflation and the desire of public sector workers to finally receive real wage pay rises are converging in a changing public mood. In the private sector, firms in a number of sectors are facing skills and talent shortages. Couple this with rapidly rising cost of living in the Dublin area and an under supply of property in key markets and there is a clear upward pressure on wages.

Figure 9

Real wages (2016 prices) of all employees index, UK, NI, ROI, 2008 - 2016 (2008 = 100)



Source: CSO, ONS,DfE

The forecasts suggest that ROI will continue to produce real terms wage increases but that the increasing inflationary pressures in NI are going to erode nominal average salary increases of c.2.5% per annum to 2020 and deliver real terms wage decreases.

Figure 10

All-island wage change (annual percentage change, real terms)

All-island wage change (annual percentage change, real terms)										
	2012	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2020**
ROI Wage Index	-1.03	0.14	1.52	3.28	3.29	1.04	1.6	1.63	1.62	2.5%
NI Earning Growth	-2.79	-2.57	-1.43	0	-0.6	-2.86	-2.01	-1.61	-1.79	1.1%

Source: Oxford Economics

At this point in time, public sector workers in ROI have been offered a pay settlement that would result in more than 90% of public sector workers achieving pay restoration from the average 6.5% reduction implemented under the Financial Emergency Measures in the Public Interest Act. Over the period to 2020, this pay proposal, if accepted, would cost the Exchequer €887m. The public expenditure context in NI does not suggest that pay settlement constraint is nearing an end though the outcome of the UK election does suggest a brake will be applied to austerity with the Scottish Conservatives and the DUP likely to press for this. Firms and governments have difficult waters to navigate in assessing what is possible in pay settlements.

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Strategic and policy implications

While Brexit will undoubtedly dominate the economic and political agenda over the coming years, there are operational and competitiveness issues that businesses and government need to keep at the top of their agenda.

Economic competitiveness matters above all else

Economic growth is improving globally, so is competition. There can be no distraction from working to improve competitiveness, whether this be at a firm level or in policy terms. From a public policy perspective rising costs in the Dublin area have the potential to cause real damage as does underinvestment in infrastructure. A desire to see growth more widely spread is challenging but sensible to explore. Similarly, in Northern Ireland, a legacy of infrastructure underinvestment will see the region fall behind many UK cities making progress in this area. Pinch points in skills availability need addressing across the island.

Businesses need to be prepared and proactive

Emerging trends in automation, the data revolution and new ways of working are fundamentally altering the way we work and the world around us. New sectors, ever more connected and ever more demanding of internet speed and capacity are beginning to emerge. Pace is crucial as the landscape changes, with firms needing to chase opportunities as they present themselves even if the prevailing mood is one of caution borne out of uncertainty. Businesses can assess exposure to the possible shifts under Brexit but it is a world of scenario planning rather than a strategy based purely on the most likely outcome that will be needed. Nimbleness, flexibility and responsiveness need to be key corporate principles.

Tax and organisational planning is key

Brexit poses organisational questions for businesses operating across the island. Some media reports have highlighted companies that have already made moves to secure a dual presence, north and south as part of a Brexit 'hedging strategy'. Location decisions and business structure choices will rise to prominence as the island's business base seek to avail of the potential of having two markets side by side.

Focus on the best economic outcomes for the island

There are fundamental economic and business issues that require resolution in the Brexit context (e.g. trading arrangements, movement of goods and people). There is a possibility that the necessary focus required for these issues could stray to a focus on political and constitutional issues. The short term economic issues need to take priority in both jurisdictions. In order for NI to make appropriate policy choices re-establishment of the Executive is critical, the island as a whole needs a laser focus on economic policy at this time.

Divergent prospects will impact strategy

The potential for real income squeezes to be more pronounced in NI than in the ROI and for a divergence in public expenditure plans mean that businesses need to carefully assess the impact on their sales. In ROI firms may find selling to consumers more favourable and see increased opportunities in selling products and services to government but will face much tougher conditions selling into the UK. Businesses selling to consumers in NI will face a more challenging time than they have recently, but shifts in currency will present new opportunities to perhaps compete for contracts currently held by an importer.

Ireland is at a critical economic cross-roads with Brexit, wider geopolitics and technological disruption. However, there is a real opportunity for the economy to make significant advances during these uncertain and complex times to support growth and economic prosperity therefore requiring careful consideration of marketing, advertising and growth strategies.

Conclusion

The central forecast is for a tougher period with a slowing labour market, but this is a highly contingent outlook which requires firms and government to be alert to change and planning to deal with a wide trajectory of possible outcomes.

As an economic barometer, pay and inflation are arguably the critical data to watch over the coming months. In ROI, the wage settlement picture appears to be clearer, with the public finances in a healthier position and some scope for increased spending. Linked to wages in ROI will be competition for talent, especially in the cities. There are already reports of skills shortages escalating, particularly in Dublin which are bidding wage levels up. It is already evident that inflation is biting across the UK. How this increased inflation filters through to pay demands is as yet unknown but will have a significant influence over future economic performance.

All periods of change present opportunity. The next six months should bring more clarity on Brexit and provide a more solid basis from which companies can react. From a wider policy perspective, Brexit uncertainty cannot detract from the clarity on the need to continue driving the island's competitiveness, skills and infrastructure agenda.

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ED None. Images sourced from Shutterstock.com