Group Economics

Its productivity, stupid

Ulster Bank

Contact: Richard Ramsey
Chief Economist, Northern Ireland
02890 276354 or 07881 930955

Richard.ramsey@ulsterbankcm.com
www.ulstereconomix.com
Twitter @UB_Economics

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During George Osborne's reign at the Treasury, addressing the UK's productivity challenge took a back seat role to tackling the deficit. In Osborne's first budget statement (June 2010) the word productivity wasn't even mentioned. Conversely, 'deficit' was uttered 19 times. Indeed, six of the former Chancellor's budget speeches failed to mention the word productivity at all. However, Osborne's last two budgets did see a new focus on productivity with the word appearing 11 times in March. This was perhaps in recognition of the UK's woeful productivity performance which couldn't be ignored any longer. Tackling the deficit assumed productivity growth would hold up. It didn't.

Productivity is one of those 'dry as dust' terms, the dullness of which conceals its crucial importance. How much we produce when we turn up to work – our productivity – determines how much we can earn. This, alongside inflation (cost of living) will influence our overall standard of living. From a government perspective, how much individuals earn will determine tax receipts and ultimately influence what public services a nation or region can afford. In fact, the UK's dire productivity performance is a major factor behind the current poor state of the public finances.

Last month Philip Hammond put productivity back on the agenda by becoming the most prolific user of the productivity word in budget statements. The word appeared 14 times in his first and last Autumn Statement speech.

The new Chancellor put the shocking scale of the UK's productivity gap with its international competitors into perspective. "We lag behind the US and Germany by some 30 percentage points. But we also lag behind France by over 20 and Italy by 8".

So what? This means that the average UK worker produces by Friday at 5pm what our best-performing peers manage by Thursday lunchtime. It is worth remembering that the UK's productivity performs conceals considerable divergence; London being the most productive and Northern Ireland the least. For perspective, the average worker in Northern Ireland finishes up on a Friday afternoon what their counterparts in Germany and the UK would have produced by close of play on Wednesday and Thursday respectively. Match their performance and we would be considerably better-off. Indeed, just narrowing the gap with our regional and international peers would improve our standard of living immeasurably.

Low productivity is not a new ailment; like the biblical poor, it seems always to have been with us. Similarly closing the productivity gap is not new either. Under the Labour Government in the late 1990s, early 2000s, the long-term ambition for the next decade was for the UK to have a faster rise in productivity than its main competitors. Addressing the productivity gaps would focus on targeting the five productivity drivers: skills, competition, enterprise, innovation and investment. Northern Ireland strategies leapt on the productivity bandwagon too. However, only four of the five drivers were adopted *(competition was excluded)* which led economists at the time to joke that productivity was 80% of the UK average as we only have 80% of the drivers!

Despite some improvement in productivity performance, overall progress was poor and disappointing. The economic downturn also led to a shift in emphasis away from productivity towards jobs at both the national and regional level. The labour market headlines make for encouraging reading with both Northern Ireland and the UK posting record employment rates. Favourable comparisons are regularly drawn against our European counterparts' sluggish economic growth rates and high unemployment rates. Indeed, last month Philip Hammond drew attention to the fact that the IMF expects the UK economy to expand at 1.4% in 2017, in line with Germany and above many of its European neighbours.

However, this makes for a feeble comparison when you consider that the UK's headline economic growth performance is flattered by demographics - a growing population and increasing levels of inward migration. Germany's working age population has fallen by 3% between 2000 and 2015 whereas the UK's increased by 10%. It is GDP per person that matters and beyond that GDP per hour worked that are the meaningful metrics to benchmark ourselves.

Let's look at Northern Ireland private sector output. A private sector recovery has been in train for around three years. However, despite this pick-up in activity, Northern Ireland's private sector has only recouped 55% of the output lost during the downturn. As a result, the private sector in Q2 2016 produced the same level of output as it did 11 years ago! This same output is produced by an additional 55,000 workers (a 12% rise). This illustrates plummeting productivity and highlights the high concentration of low value-added, low-waged jobs that the Northern Ireland economy has generated. It is economic output per person that matters.

To quote the Nobel Prize winning economist Paul Krugman (1994) said *"Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise output per worker".*

In September, Simon Tilford of the Centre for European Reform presented a sobering analysis of the UK's economic performance - "Brexit Britain: The poor man of Western Europe?" Contrary to popular belief, the UK has not been one of Europe's economic stars over the last 15 years. Adjusting for living costs, exchange rates and demographic trends, the UK in 2015 is now poorer relative to the EU-15 (Eurozone) than it was in 2000.

Northern Ireland has been consistently at or close to the bottom of the regional economic growth table since 2008. Given that our population has been rising over this period, GVA per head (regional economic prosperity) has been diluted further.

Regional policy viewed through the prism of narrowing regional economic inequalities throughout the UK has failed. Indeed, last Friday the Bank of England's Chief Economist, Andy Haldane highlighted that regional differences in the UK are amongst the highest in the EU. Spreading wealth across the UK and fashioning a new industrial strategy has featured prominently in Theresa's May's speeches to date. Last month the centrepiece of the Chancellor's Autumn Statement announcement was the National Productivity Investment Fund (NIPF). It will have £24 billion to spend over the next five years on transport, digital communications and research and development. Each of these is central to enhancing productivity growth and the commitment of resources to go alongside the National Infrastructure Plan is encouraging. Northern Ireland will gain around £275m to invest as it sees fit.

Northern Ireland could do well to follow the UK in revisiting its economic strategy. Reducing corporation tax to 12.5% was the flagship policy aimed at significantly improving Northern Ireland's economic performance by attracting higher productivity firms to Northern Ireland that pay higher wages and encouraging indigenous firms to invest and expand to do the same. However, a fog of uncertainty has descended on the merits of such a policy (and the appropriateness of NI's economic strategy) following Brexit and Donald Trump's pledge to slash US corporation tax to 15%.

Improving productivity needs to feature more prominently locally. After all productivity improvements are the best way to safeguard jobs. Arguably this should focus less on providing subsidies to individual firms and provide greater emphasis on investing in world class economic infrastructure that will benefit all businesses and the economy at large. Northern Ireland also needs to change its mind-set away from spending to investing. Northern Ireland tops too many regional league tables for spending money (e.g. welfare). This will not improve the long-term economic prosperity of the people of Northern Ireland. Northern Ireland needs to redouble its efforts in investing in skills, telecommunications and transport infrastructure. Topping the regional league tables in these areas will yield dividends.

Richard Ramsey
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