PART F – THE ECONOMIC OUTLOOK

12. Economic Background and Outlook

International developments

The global economy has gained some momentum so far in 2017, with most of the world's major economies expected to grow more quickly than last year. The OECD expects global growth to be 3.5% this year, an acceleration from 3.1% in 2016. This has been boosted by growth in world trade and accommodative monetary and fiscal policy.

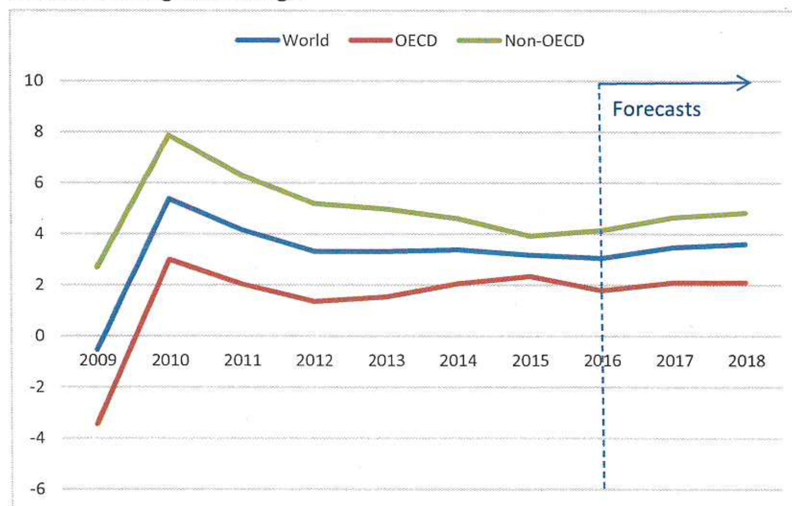
Among advanced economies, the United States, the Euro area and Japan have all shown signs of significant improvements in 2017, while the United Kingdom economy is forecast to continue its gradual slowdown through 2017 and into 2018. China is expected to maintain a similar growth rate, while strong growth in India will weaken somewhat and both Russia and Brazil will recover from contractions last year.

However, the OECD does point to some potential weaknesses in the global economy which could disrupt the current momentum:

- Private sector investment has not recovered in the current recovery to the same extent as in previous recoveries
- Inflation and wage growth remain low
- Emerging economy debt is high and further reforms are needed.

Figure 43: World economic growth

Annual average % change



Source: OECD Economic Outlook June 2017

The UK's vote to leave the EU has caused some uncertainty within the UK but this does not appear to have spread to other parts of Europe, or more widely. The impact on the UK is now expected to be more prolonged than previously anticipated, with a gradual slowdown over a number of years rather than any short, sharp recession. The longer-term implications are very much dependent on the outcome of ongoing negotiations with the EU, and on how businesses respond.

Jersey economy

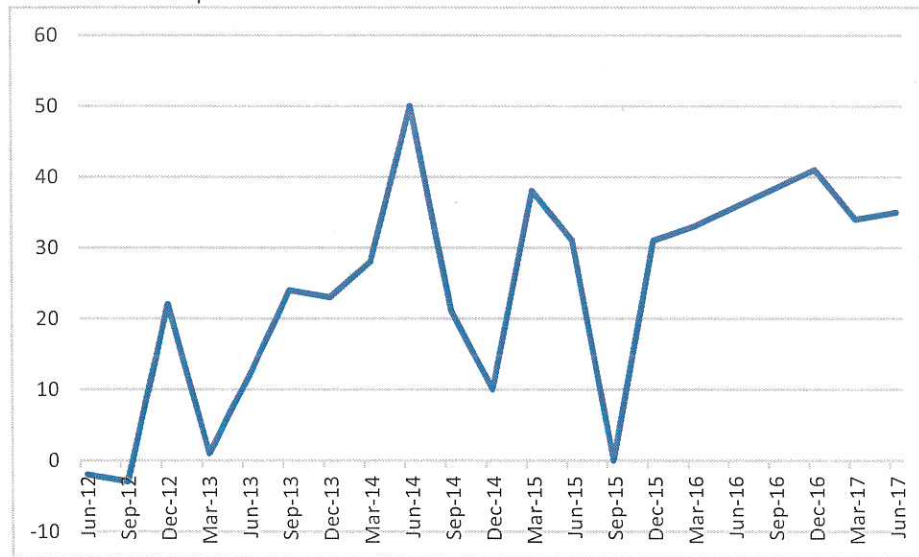
The Jersey economy grew by 1% in 2016, as measured by Gross Value Added (GVA). This was higher than expectations (0.2% growth), and the third successive year of growth. The GVA of the finance sector fell by 2%, driven by falls in the banking sector. The construction sector grew by 8%, hotels, restaurants and bars by 7% and other business activities by 6%. GVA fell for both public administration (by 4%) and wholesale and retail (3%).

The Business Tendency Survey (BTS) gives a more recent picture of the economy. The BTS has continued to paint a positive picture overall, with the headline business activity indicator having been positive since June 2014. The majority of the other indicators are positive or neutral, with the exception of input costs which is at its most negative level to date.

For the finance sector, the BTS has been consistently positive in recent rounds. Business activity is strongly positive, with a net balance of +35, indicating that that the proportion of businesses (weighted by employment) reporting an increase in activity was 35% higher than the proportion reporting a decrease. Expectations for future activity were also high, and business optimism has remained positive since 2013.

Figure 44: Finance business tendency results – business activity indicator

% balance of respondents

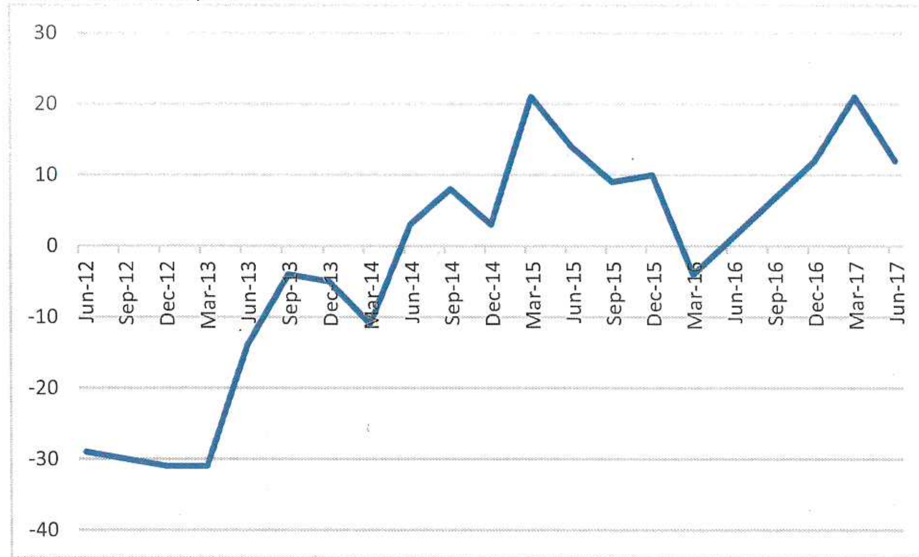


Source: States of Jersey Statistics Unit

Non-finance has been generally positive for the three most recent quarterly surveys, although profitability remains under pressure as input costs rise as a result of weaker sterling.

Figure 45: Non-finance business tendency results – business activity indicator

% balance of respondents



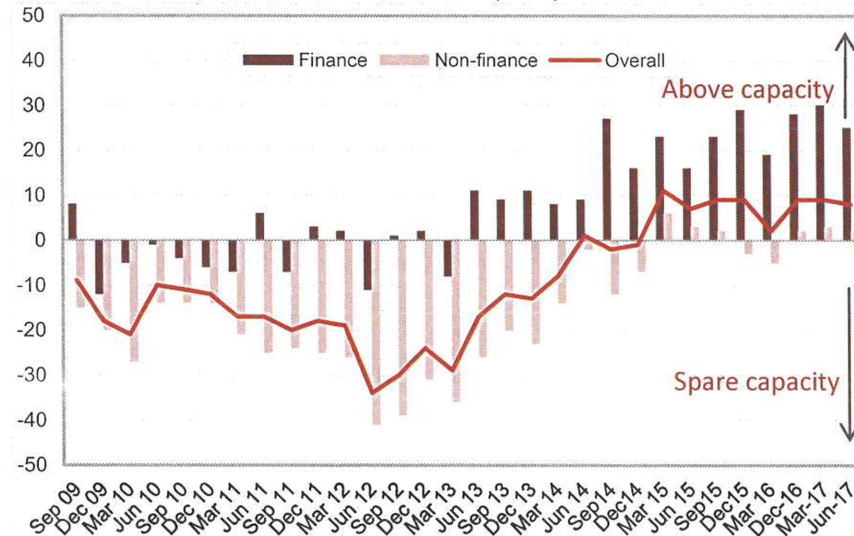
Source: States of Jersey Statistics Unit

The BTS also provides some data on firms' perceptions of whether they are working above or below capacity. This is potentially an indicator of the amount of spare capacity in the economy as a whole, alongside other indicators including global economic growth, the competitiveness of financial services, trends in Jersey GVA, labour market trends and the ability of businesses to employ people locally.

Figure 46 shows that overall, a larger proportion of firms (weighted by employment) are operating above capacity than are working below capacity. However, while the responses from the finance sector suggest a large number of firms have been above capacity in recent years; for non-finance the net balance is relatively neutral.

Figure 46: Capacity utilisation

% balance of respondents above/below capacity

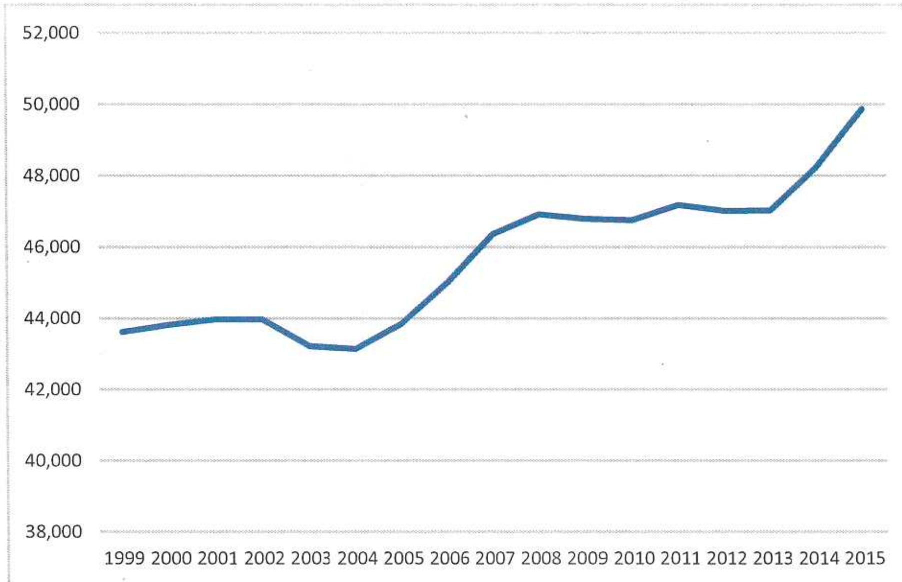


Source: States of Jersey Statistics Unit

Employment growth has also been strong, with 2016 seeing both the highest June number of people in employment to date and the highest December number to date. Numbers actively seeking work has been falling at the same time, with an annual reduction of almost 30% to June 2017.

Figure 47: Employment trends in Jersey

% change in private sector employment in December each year compared to a year ago

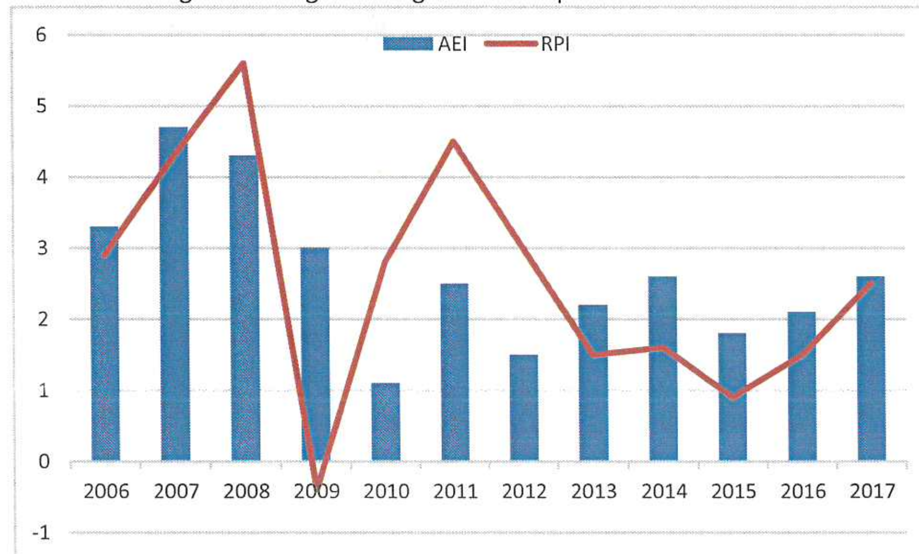


Source: States of Jersey Statistics Unit

Another positive indicator from the labour market is that average earnings have grown in real terms for five successive years. However, this follows a number of years of falling real earnings and in 2017 higher inflation means that earnings growth only exceeded inflation by 0.1%. Overall, average earnings have grown by only 0.1% in real terms over the last ten years.

Figure 48: Earnings growth and inflation

Annual % change in average earnings and retail prices index

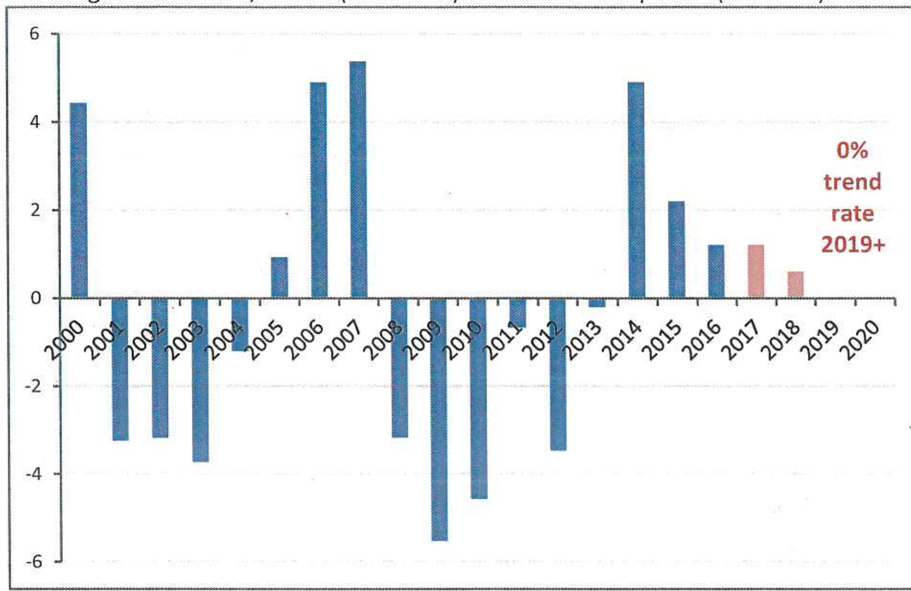


Source: States of Jersey Statistics Unit

The Fiscal Policy Panel last updated their economic assumptions in August 2017. Growth in 2017 was forecast at 1%, falling to 0.5% in 2018. However, the Panel have stated that considerable uncertainty remains regarding the likely short- and long-term economic implications of the UK's exit from the EU and around the performance of the finance sector.

Figure 49: GVA trends

% change in real GVA, actual (blue bars) and FPP assumptions (red bars)

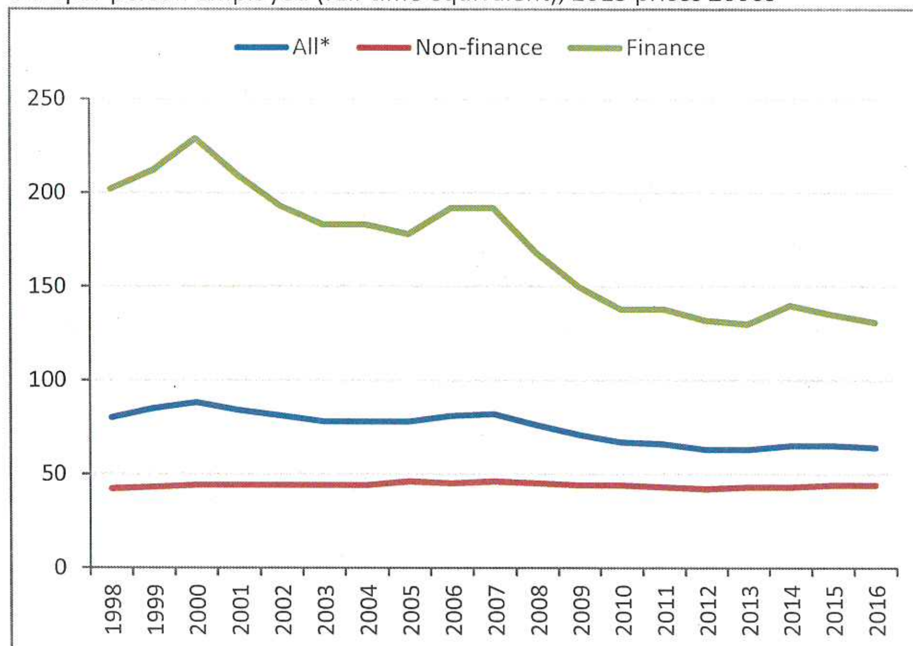


Source: Fiscal Policy Panel

The lack of productivity growth over previous economic cycles has been of particular concern and the most recent trends are not yet showing any real improvement. 2016 saw productivity (as measured by GVA per FTE) fall 2% in real terms. Productivity in the finance sector fell by 3%, primarily due to falling productivity in trust and company administration. Productivity for non-finance was flat, with increases in sectors including hotels, restaurants and bars, and construction, with falls in wholesale and retail and other business activities.

Figure 50: Productivity growth in Jersey

GVA per person employed (full-time equivalent), 2013 prices £000s



*All sectors and non-finance exclude rental

Source: States of Jersey Statistics Unit

The FPP emphasised in their 2016 Annual Report the importance of raising Jersey's productivity performance:

> *"Improving Jersey's underlying rate of productivity growth is vital to raising Jersey's economic performance and competitiveness, improving public finances and ultimately raising the standard of living particularly as the underlying demographic changes start to have more of an effect."*

The Council of Ministers remains committed to playing its part in trying to achieve this. The MTFP 2016-2019 sets out significant investment in health, education, St. Helier and the Island's infrastructure. This supports the approach set out in the Strategic Plan to improve productivity performance and optimise economic growth by:

- Supporting Digital Jersey to promote jobs and growth in the technology sector, with a focus on Fintech
- Enhancing the existing Financial Services Policy Framework
- Developing a new and challenging Enterprise Strategy
- Implementing the recommendations of the Tera Allas Review to establish a new Innovation Strategy
- Attracting more inward investment through the activities of Locate Jersey
- Reviewing and upgrading the existing skills strategy with support from the Economic and Productivity Growth Drawdown Provision
- Implementing the Oxera recommendations to develop a new competition framework.

Jersey's fiscal position

In their letter to the Treasury and Resources Minister in August 2017 the FPP also stated that in the light of the latest economic and fiscal developments:

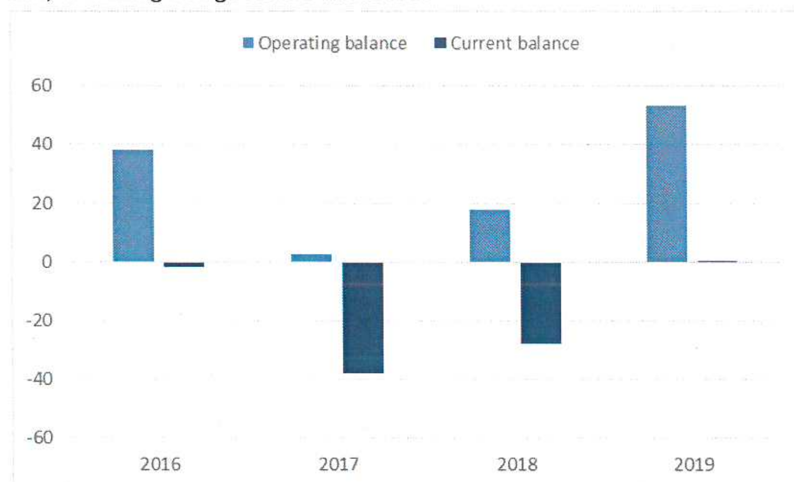
> *"It is therefore imperative that equivalent expenditure and/or revenue measures are put in place to deliver the same degree of fiscal balancing as previously planned in the MTFP Addition by 2018/19."*

The Council of Ministers has framed Budget 2018 to follow this advice and previous FPP recommendations to address any structural imbalance in States finances by 2018/19 whilst being careful about the impact on the economic recovery.

Figure 51 shows the latest financial forecast after the measures proposed in Budget 2018 are taken into account. By 2019 there is expected to be an operating surplus of just under £55m and after depreciation is taken into account this will mean that current budget is in balance. The current budget position by 2019 is therefore expected to be similar to that at the time of the MTFP Addition. This means that the current advice of the FPP will be met and that any underlying structural mismatch between revenue and expenditure should have been broadly addressed by 2019.

Figure 51: States operating and current budget position

£m, including Budget 2018 measures

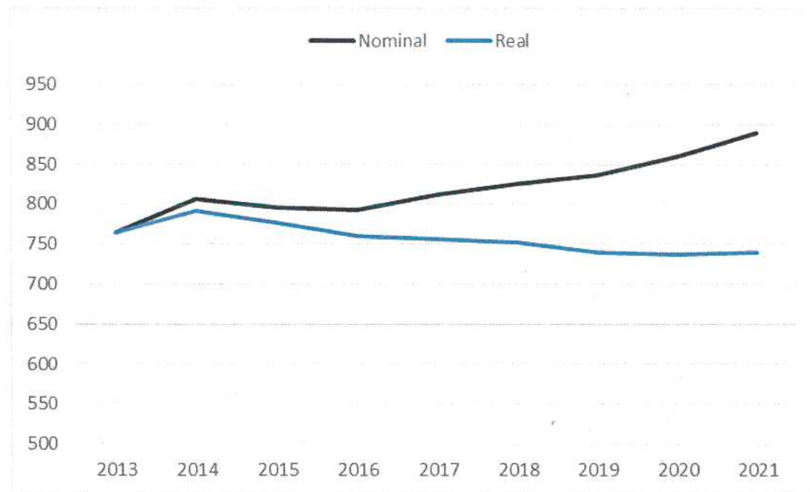


Source: Treasury and Resources Department

One of the factors contributing to the expected improvement in both the operating position and the current budget is that total Consolidated Fund revenue expenditure is not expected to increase in real terms and by 2019 will be about 2.5% below what it was in 2016 in real terms.

Figure 52: Trend in total Consolidated Fund revenue expenditure

£m, real in 2013 prices



Source: Treasury and Resources Department

This analysis of expenditure trends does not include capital expenditure. To get a better understanding of how the States' fiscal position - after capital spending - will impact on the economy in coming years it is possible to adjust the operating balance to take account of what will actually be spent on capital projects rather than what is allocated. It is also possible to include what the impact will be from the balance on other States funds such as the Social Security and Health Insurance Fund (HIF).

Figure 53 shows how this calculation can be built up. Firstly the initial operating balance is adjusted for the best estimate of the capital expenditure profile. There are large adjustments to account for the scale of capital expenditure on key projects such as social housing, sewage treatment works, a new secondary school, the new hospital and by the subsidiary companies SoJDC[14], Andium Homes and Ports of Jersey. A large part of this capital expenditure is not financed from tax or other revenue taken from the economy in the year that it is spent and therefore alters the position quite significantly. On this basis the net fiscal position moves from a broadly neutral position in 2016 to one where it is adding significant stimulus throughout the 2017-2021 period.

Figure 53: Adjusted fiscal position

£m	2013	2014	2015	2016	2017	2018	2019	2020	2021
Operating balance	1	-17	-5	38	2	17	53	55	55
Balance after cap x*	-43	-69	-87	-44	-211	-313	-234	-248	-235
Adj. for trading fund	-37	-69	-84	-32	-199	-314	-231	-241	-226
Adj. for Soc Sec/HIF	-31	-62	-70	2	-173	-302	-230	-225	-218

*includes future hospital

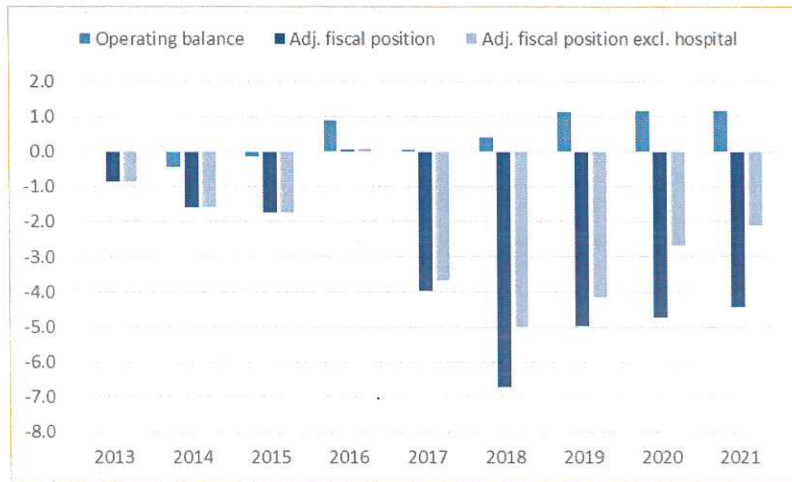
Source: Treasury and Resources Department

[14] States of Jersey Development Company

The chart below shows that the adjusted balance and extent of the stimulus to the economy is also large relative to the size of the economy in the 2017-2021 period. The adjusted fiscal position goes from near balance in 2016 to one where spending in the economy exceeds money withdrawn by between 4% and 7% of GVA over 2017-21. This does include the large impact of new hospital – which may be subject to project specific risks. If this project is excluded from the analysis the chart below also shows that the stimulus is still likely to be large and between 2% and 5% of GVA over the period. This is driven by the activity of Andium Homes and the SoJDC which add over £100m of capital expenditure each year over the period.

Figure 54: Operating balance and adjusted fiscal position

% of GVA



Source: Treasury and Resources Department

This does suggest that significant fiscal support will remain in place while the economy is expected to remain below capacity in the immediate years. However, the scale of fiscal support in the later years is also large and could take place at a time when the economy may be returning to capacity. This brings the risk that fiscal policy may not act in a counter cyclical way. There is of course much uncertainty about the exact performance of the economy in coming years, as highlighted by the FPP in their August letter to the Treasury and Resources Minister.

This is a high level assessment and it will be important to consider in practice how capital expenditure and construction related spend actually impact on the economy in any given year or with reference to particular projects. For example, whether there are large projects that spend a high proportion on imported capital equipment and/or a high proportion on employment in the Jersey economy. In addition, the timing of key projects could change which could significantly alter the profile of capital expenditure. It will be important to also consider what the level of activity is in the private sector both as whole or in similar sub-sectors to the States projects.

For these reasons the scale and impact on the local economy of the States capital programme will need to be monitored and kept under review. If necessary, adjustments or compensating measures will be considered if required in future years. If the economy is expected to be close to capacity at any point and the States capital programme combined with private sector activity risks a build-up of inflationary pressure then this will be carefully managed to limit the demands on local resources and ultimately the impact on the economy. The Council of Ministers will respond as required if FPP advice ahead of Budget 2018 or in future reports suggests steps need to be taken to limit the impact on the local economy of the important investment planned.

The risks around managing the impact of the States capital programme are only one set of uncertainties that the Island faces at the moment. The FPP stated in their August letter to the Treasury and Resources Minister regarding the uncertainties the Island faces:

> *"On assessing the situation in Jersey we have concluded that the significant levels of uncertainty that we identified in our 2016 Annual Report and reiterated in our letter to you in March this year remain. That is, considerable uncertainty regarding the likely short- and long-term economic implications of the UK's exit from the EU, and the impact on Jersey, and the on-island uncertainties around the financial sector's performance."*

The Council of Ministers has listened to this and previous FPP advice to ensure that fiscal plans can be flexible in the face of such uncertainties and can adapt to changing economic circumstances. The improved Consolidated Fund balance as result of the Budget 2018 plans are a key element of this flexibility. As highlighted earlier in this section, the latest economic indicators are generally positive and indicate the Jersey economy to be performing well despite these uncertainties.

Nonetheless, should economic conditions change the Council of Ministers retains this flexibility to alter its plans should future advice from the FPP indicate this is necessary. At this stage it is not clear that such a change is warranted and the current uncertainty should not act as a distraction from addressing any structural imbalance in States finances.

If the current economic uncertainty materialises into a deterioration in economic conditions then subject to FPP advice there are a number of options for offering further support to the local economy:

- Allow the automatic stabilisers (increased spending in areas such as benefits and/or lower revenues as economic activity slows) to adjust and help smooth any impacts on the economy.
- Funding could be placed in the Stabilisation Fund (from the Consolidated Fund, contingencies or reserves) and used to support discretionary policies that can support the economy in a timely, targeted and temporary manner.
- The Economic and Productivity Growth Drawdown Provision (EPGDP) is in place and can be used to support policies that can increase economic growth and mitigate the economic impacts of the UK's withdrawal from the EU.

Despite the economic uncertainties that the Island and the international economy currently face, if the measures set out in Budget 2018 are adopted then States finances remain on course to balance the current budget by 2019. This has been the consistent advice of the FPP and something the Council of Ministers has repeatedly set out to achieve in this MTFP period. FPP advice in future reports will be critical to determine whether this approach needs to change or whether any additional measures may be needed in the future. However, in the meantime the Council of Ministers plan through the measures proposed in Budget 2018 to keep finances on track with existing advice. The relatively strong performance of the economy into 2017 makes it a more conducive economic environment in which to achieve this.