Jersey's Fiscal Policy Panel

Deputy Susie Pinel

Minister for Treasury and Resources

30 March 2022

Updated Economic Assumptions

Dear Minister,

Thank you for your letter on 17 March. The Panel is acutely aware of the challenges of rising global inflation and the economic impacts arising from the tragedy unfolding in Ukraine. We have updated our economic forecasts and provided new fiscal advice to address your questions. Please find our updated economic assumptions at Annex 1.

The Panel's 2021 annual report stated that '*a further significant increase in inflation over the next 6-9 months appears highly likely at this stage*,' and short-term inflationary pressures have increased markedly further since. Supply chain pressures, largely resulting from the bounce back after the Covid-19 pandemic, have pushed up shipping prices and commodity prices have risen above pre-pandemic levels. This is having a knock-on impact on the cost of living.

This has been exacerbated by the Russian invasion of Ukraine, which will continue to impact on commodity prices. Russia currently supplies 40% of Europe's natural gas consumption and 27% of oil imports. Whilst UK and Jersey direct reliance on Russian energy imports is lower, reductions in supply are translating to higher prices globally. Decisions by western governments to reduce their reliance on Russian imports will likely mean higher energy prices will persist for at least the next year. The response from other oil and gas producers may mitigate some of the commodity price rises but higher inflation is set to have a negative impact on economic growth.

Jersey’s headline inflation rate, at 3.8% in December 2021, currently appears low when compared to other nearby jurisdictions with Guernsey, the Isle of Man and the UK all reporting higher inflation in December. However, inflation is likely to rise sharply over the coming year. Inflation forecasts for the UK have been revised upwards on several occasions and the Office for Budgetary Responsibility now expects a peak of 8.7% in 2022, up from 5% expected less than 6 months ago. In the past, Jersey’s RPI inflation rate has closely tracked UK inflation. However, the significant revisions that the OBR have made in the last 12 months shows how challenging the circumstances are in making these forecasts in such an uncertain political and economic climate.

Whilst prices in Jersey are likely to increase further into 2022, the rise may be less than in the UK due to differences in Jersey’s energy mix, and the supply impacts affecting different energy sources to varying degrees. In particular:

- The share of gas is higher in UK due to the greater use for residential heating and electricity generation. Gas prices have recently risen at a faster rate than other energy sources.
- In Jersey, heating oil and liquid petroleum gas (LPG) are more prevalent heating sources, and have been subject to smaller price increases.
- Electricity in Jersey is largely sourced from hydroelectric power and nuclear power, which are less vulnerable to global energy shocks and are subject to long-term pricing agreements.
- However, the invasion of Ukraine means that oil prices will likely push up the cost of oil and potentially gas heating in Jersey and put upward pressure on electricity prices over 2022, as any long-term contracts expire.

Annex 2 shows the inflation outlook for Jersey to 2026 including the economic assumptions for the next eight quarters for RPIX inflation. This shows RPIX inflation is likely to peak at around 5.9% in 2022, which is the highest rate in over 10 years. Inflation is expected to remain elevated for the next 1-2 years, before gradually falling back to the long-term trend rate of 2.5%. Annex 1 also shows the projections of other economic indicators, including RPI and RPIY, but as a panel we have focussed on RPIX for the forward look.

Monetary policy is the most appropriate tool for combatting general inflationary pressures and the Bank of England has increased Bank Rate three times in the last four months. Future rate rises are more uncertain due to worsening of economic conditions resulting from the Ukrainian invasion, however, the market still expects further rises this year with a higher profile than the Panel's August 2021 economic assumptions across the entire forecast horizon. Whilst this will dampen aggregate demand pressure somewhat, it will not bring Jersey's inflation rate back down immediately.

The duration of heightened inflation will depend to some extent on the response of wages – though given the external nature of this price shock some falls in real wages will be required.

Data suggests a growing economy and a tight labour market:

- Registered unemployment fell to 730 in March 2022, which was the lowest on record since comparable figures in 2008.
- The December 2021 Business Tendency Survey showed a positive business sentiment in financial services, but a less positive picture for hospitality and retail – reflecting the reintroduction of some public health measures. Input costs were seen as a negative factor for all sectors – providing another sign of inflation pressures and affecting profitability, which was negative for all sectors other than financial services.

- House prices showed further growth in 2021 growing by 16%. This meant a £105k increase in the median price of a 3-bed house.
- Employment bounced back to pre-pandemic levels from June 2019 to June 2021 with total number of jobs at 62,430.
- Average earnings were 3.3% higher in June 2021 than the year before.

This means that, other than inflation, economic data looks broadly more positive than our projections in March 2021. Regarding the pandemic, it is worth staying alert to new variants and waning immunity, which represent a downside risk.

Looking forward, the expectation for higher interest rates represents a marked change from the Panel's last economic assumptions in August and will likely have a strong positive impact on banking profits. Jersey is primarily a deposit-taking centre and interest rate rises usually lead to increase in net interest margins. Further, data published by the Jersey Financial Services Commission showed that aggregate operating costs at Jersey Incorporated Banks (JIBs) continued to fall in 2021 – suggesting potential one-off efficiency savings for the sector. Finance sectors profits are forecast to be 26% higher this year and a further 36% higher in 2023 which represents a considerable upwards revision from previous forecasts. The forecast increases in finance sector profits drive up GVA over the next two years.

The rest of the Panel's updated forecast is:

- Faster employment growth in the early part of the forecast, reflecting strong momentum in the labour market recovery.
- A continued tight labour market, with resultant wage pressures – particularly in areas where staff are difficult to find. But due to high inflation, average earnings are expected to fall in real terms in 2022 and 2023.

- Non-finance GVA gradually reversing the falls sustained in the pandemic as the labour market and profitability recover.
- A higher profile of interest rates across the forecast horizon reaching a peak in 2023.
- Continued strong growth in house prices, albeit less rapid than in the last two years, in the initial years of the forecast before returning to trend.

The overall impact of the revisions to the forecast results is an upgrade in the forecast of GVA in 2022 to a 5.1% increase. This will mean that GVA is at a higher level than was forecast pre-pandemic, which is largely driven by the marked change in interest rate expectations. GVA growth is expected to fall in later years of the forecast following a path of market expectations for falling interest rates. The timing of future Bank Rate changes is very uncertain, which will impact the exact path of GVA.

Whilst the upward revision of economic output is positive and will lead to greater tax revenues, the economic experience of Islanders will likely feel quite different due to rising cost of living with real earnings falling in most sectors over the next two years.

The ongoing situation in Ukraine adds uncertainty to economic conditions particularly inflation and consequently interest rates, which will impact several of the Panel's economic assumptions. The Panel will provide a new updated set of assumptions in August.

Fiscal outcomes and advice

The publication of the Annual Report and Accounts will set out the overall fiscal performance in 2021. Given the upgrade to the economic assumptions, it is likely there will be an improvement in the budgetary balance in the early years of the forecast if policy remains unchanged. It would be sensible to use any surpluses to rebuild the Stabilisation Fund or to pay off debt to build the resilience of the public sector balance sheet. The Panel previously estimated the semi-elasticity of government borrowing/saving in response to the 1% of economic growth to be 0.16%. This means that if the economy grows 1% then we would expect government net spending (i.e. spending less revenues) to fall by 0.16% of GVA automatically – without any changes in fiscal policy. Based on latest economic assumptions, the economy will be 0.7% above capacity in in 2023 which would by itself warrant a transfer of 0.11% of GVA, or £7m to the Stabilisation fund (or reductions in debt) in 2023. Added to this the increase in banking profits due to higher interest rates would suggest an even larger transfer is appropriate. The impact of financial sector profits on public finances is an issue the Panel will revisit in its August assumptions.

Rising inflation will mean increased pressures on households' budgets, and it remains inadvisable to attempt to compensate or provide support to all Islanders as this would simply boost nominal demand further and add to inflationary pressures rather than growth. However, using some of the better than expected fiscal outcomes to ameliorate the impacts of the global supply issues would be a reasonable course.

The Minister has requested the Panel to consider the feasibility of capital programmes given their impact on providing stimulus to the economy and a potential lack of spare capacity in the construction industry. Capital programmes will add stimulus and potentially some inflationary pressures, however, it remains sensible to continue with current capital programmes given they support public services and can contribute to long-term economic growth and productivity. Adjusting capital programmes cyclically is notoriously difficult. The Business Tendency Survey in December 2021 suggests neutral to mildly negative business activity and future business activity for the construction industry indicating that there may be some spare capacity in the construction industry. However, it remains advisable to consider whether there are sufficient resources to deliver both the government and private sector programmes planned in coming years.

Medium-term report

The Panel will provide a medium-term report and updated economic assumptions later this year to inform the fiscal forecasts which underpin the Government Plan 2023-2026. The medium-term report will update the longer-term trend forecasts for the key economic variables. These have a longer-time horizon than the Panel's economic assumptions and look forward over a 10-15 year time frame. The trend forecasts were last updated in the '*Advice for 2020-23 Government Plan'* which include assumptions around participation rate, migration growth and employment growth. The Census is likely to provide more information on the Jersey labour market and population and will help to improve the accuracy of the trend forecasts. The Panel will also update its fiscal advice in light of economic trends including around the appropriate levels of transfers to reserves. The Panel will comment on the Social Security Funds after the actuarial review is published which it understands to be currently scheduled for early 2023.

The medium-term report will be published soon after the new government is established. The Panel looks forward to working with the new Council of Ministers and support them going forward. It is grateful to the current Treasury Minister for our constructive relationship and is pleased that its recommendations have been taken forward to support a strong economy.

Yours sincerely

Kate Barker

Kate Barker (Chair)
Francis Breedon and Richard Davies

Annex 1: Updated economic assumptions

March 2022 forecast

% change unless otherwise specified	2020	2021	2022	2023	2024	2025	Trend 2026+
Real GVA	-8.7	6.0	5.1	7.7	-0.2	-0.8	0.6
RPI	1.3	2.7	5.8	4.6	2.9	2.1	2.6
RPIY	1.2	2.7	5.3	3.6	2.5	2.4	2.5
Nominal GVA	-7.2	8.8	10.6	11.6	2.3	1.6	3.1
Gross operating surplus (including rental)	-15.5	13.2	17.1	20.6	1.4	0.2	3.2
Financial services profits	*-18.1*	*19.5*	*25.7*	*36.1*	*-0.9*	*-3.1*	*3.4*
Compensation of employees (CoE)	0.2	5.4	5.4	3.6	3.2	3.0	3.1
Financial services CoE	*1.5*	*3.5*	*5.7*	*4.0*	*3.4*	*3.3*	*3.4*
Non-finance CoE	*0.0*	*6.5*	*5.3*	*3.4*	*3.1*	*2.8*	*2.9*
Employment	-2.4	3.0	0.9	0.7	0.6	0.4	0.4
Average earnings	1.1	3.3	4.5	2.8	2.6	2.5	2.7
Interest rates (%)	0.2	0.1	1.2	2.2	2.0	1.7	1.5
House prices	6.1	16.0	6.0	5.0	4.0	3.0	2.7
Housing transactions	-3.8	15.1	3.5	3.0	2.5	2.5	1.5

*Trend interest rates represent market expectations for 2026

August 2021 forecast

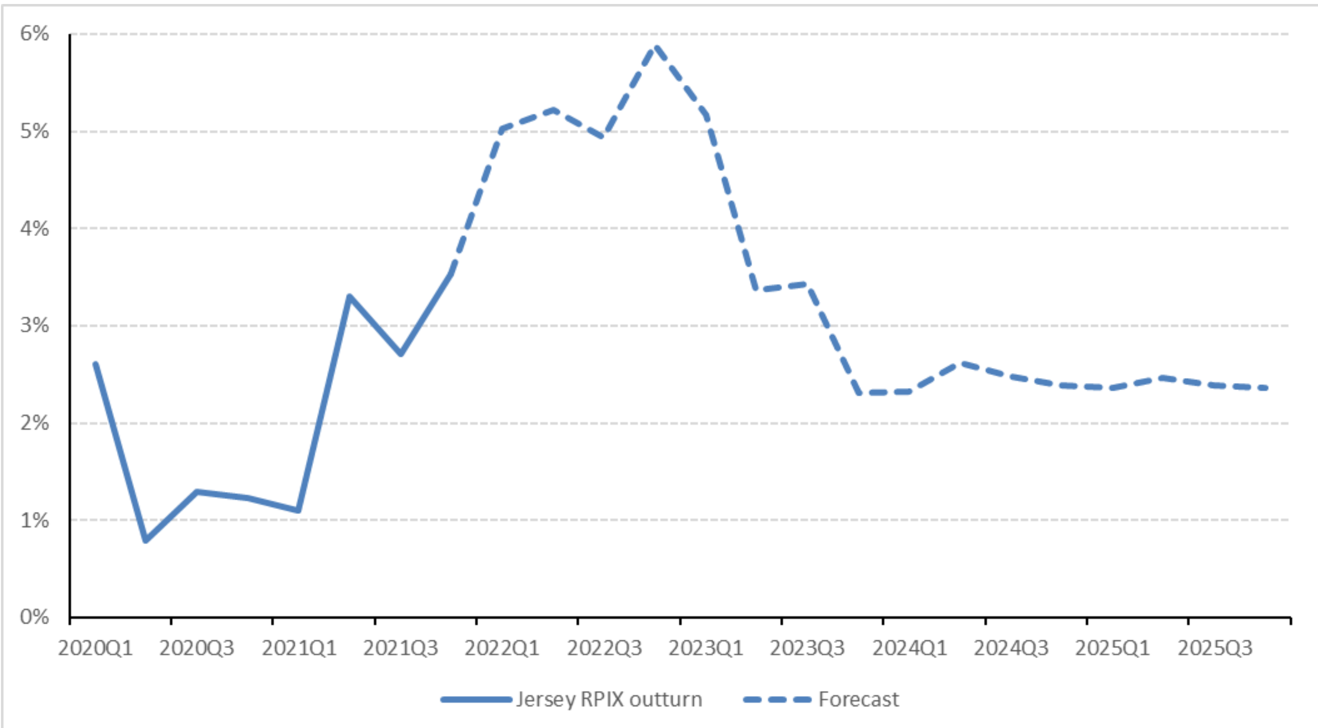
% change unless otherwise specified	2020	2021	2022	2023	2024	2025
Real GVA	-9.3	2.2	2.8	3.3	1.6	0.6
RPI	1.3	3.0	3.6	2.6	2.5	2.6
RPIY	1.2	3.0	3.5	2.5	2.4	2.5
Nominal GVA	-8.0	4.8	6.2	5.7	4.0	3.1
Gross operating surplus (including rental)	-17.7	6.1	10.2	9.2	5.2	3.2
Financial services profits	*-27.5*	*4.0*	*14.4*	*16.9*	*7.5*	*3.4*
Compensation of employees (CoE)	0.5	3.8	3.2	3.0	3.0	3.1
Financial services CoE	*1.5*	*3.5*	*3.5*	*3.5*	*2.8*	*3.4*
Non-finance CoE	*0.0*	*3.9*	*3.0*	*2.7*	*3.0*	*2.9*
Employment	-2.4	1.1	1.0	0.8	0.9	0.4
Average earnings	1.1	2.6	2.2	2.1	2.1	2.7
Interest rates (%)	0.2	0.1	0.2	0.5	0.5	0.6*
House prices	6.1	5.0	4.0	3.0	2.0	2.7
Housing transactions	-3.8	5.0	3.5	3.0	2.5	1.5

*Trend interest rates represent market expectations for 2026

Change since August 2021 forecast

% change unless otherwise specified	2020	2021	2022	2023	2024	2025
Real GVA	+0.6	+3.8	+2.3	+4.4	-1.8	-1.4
RPI	0.0	-0.3	+2.2	+2.0	+0.4	-0.5
RPIY	0.0	-0.3	+1.8	+1.1	+0.1	-0.1
Nominal GVA	+0.8	+4.0	+4.4	+5.9	-1.7	-1.5
Gross operating surplus (including rental)	+2.2	+7.1	+6.9	+11.4	-3.8	-3.0
Financial services profits	*+9.4*	*+15.5*	*+11.3*	*+19.2*	*-8.4*	*-6.5*
Compensation of employees (CoE)	-0.3	+1.6	+2.2	+0.6	+0.2	-0.1
Financial services CoE	*0.0*	*0.0*	*+2.2*	*+0.5*	*+0.6*	*-0.1*
Non-finance CoE	*0.0*	*+2.6*	*+2.3*	*+0.7*	*+0.1*	*-0.1*
Employment	0.0	+1.9	-0.1	-0.1	-0.3	0.0
Average earnings	0.0	+0.7	+2.3	+0.7	+0.5	-0.2
Interest rates (%)	0.0	0.0	+1.0	+1.7	+1.5	+1.1
House prices	0.0	+11.0	+2.0	+2.0	+2.0	+0.3
Housing transactions	0.0	+10.1	0.0	0.0	0.0	+1.0

Annex 2: Shape of FPP RPIX inflation forecast and table of quarterly year on year changes



2022				2023			
Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
5.0%	5.2%	4.9%	5.9%	5.2%	3.4%	3.4%	2.3%

Annex 3 – Letter from the Treasury and Resources Minister

Minister for
Treasury and Resources

Government of JERSEY

19-21 Broad Street | St Helier
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Dame Kate Barker

Chair of the Fiscal Policy Panel

17 March 2022

Dear Dame Kate,

The Fiscal Policy Panel's 2021 annual report, published in November 2021 identified ongoing economic uncertainty, including the longer-term impacts of Covid-19 and the recent surge in inflation. The level of uncertainty has increased significantly since then, with the Russian invasion of Ukraine, which began in February this year.

The Government of Jersey continues to stand alongside the UK and international partners in its condemnation of the actions of Russia against Ukraine. We have seen Islanders responding to the unfolding humanitarian crisis with compassion, and Jersey will do all it can to help and support the Ukrainian people, including Ukrainian nationals on Island and their families.

I understand that the Panel is currently preparing updated economic assumptions, to inform development of the 2023-2026 Government Plan. I would appreciate the Panel's views on the extent to which recent geopolitical developments might impact on the outlook for Jersey's economy.

In particular, how the recent surge in inflation may be further exacerbated by the Ukraine invasion, driven by increases in energy and commodity prices, and the extent to which this threatens to undermine the economic recovery from Covid-19. Of particular importance for Jersey is what this might mean for local energy prices, the Island's supply chain, wider inflation and any impacts on forecasted growth.

Further, I would appreciate if the Panel could give some consideration to how the recent developments might affect the fiscal advice from last year, and what further advice you might give for the future direction of fiscal policy. In addition, it would be useful to understand the Panel's view on any potential responses and recommendations when developing the financial strategy for Government Plan 2023 – 2026.

I would also appreciate any update to your previous advice to maintain strong capital investment in the current economic situation – considering both the inflation pressures in the construction industry and the capacity of the industry.

I look forward to receiving your response in due course.

Minnistre d'la Trésôr'rie et du Bein Publyi | Gouvèrnément d'Jèrri