Economic Outlook | February 2012

States of Jersey
Economics Unit

HEADLINES

- *The global economic situation deteriorated in the second half of 2011 as the sovereign debt crises in the euro area and wider fragilities in the global economy started to affect the real economy. This has resulted in a weaker economic outlook for 2012, particularly for developed economies.*
- *These international developments and the uncertainty associated with them have adversely affected local business optimism and expectations for future employment, whilst unemployment continued to rise during 2011.*
- *The latest forecast for the Jersey economy shows growth of -2% to +2% is anticipated in 2012. The increased global uncertainty generated by the continued euro zone crisis will mean that the risks to these forecasts are now even more to the downside.*
- *RPI inflation fell to 5% in December 2011, suggesting that the downward trend anticipated in the last Economic Outlook is beginning to materialise. RPI is forecast to fall further this year to 3% by the end of 2012 as the impact of GST falls out and commodity price pressures continue to ease. Interest rates are now not expected to increase until mid 2014.*

INTERNATIONAL ECONOMY

During 2011 the global economic situation worsened. The search for a credible resolution to the sovereign debt crises in parts of the euro area continues. A consequence of it being drawn out for so long now is that it has started to impact on economies by reducing the availability and increasing the price of credit. In addition, countries have had to plan for further fiscal consolidation by reducing expenditure or increasing tax. This has reduced expected future economic growth and employment in the euro area and in turn damaged the prospects of developing economies around the world that would have otherwise benefitted from greater levels of trade with them. Limited progress on fiscal consolidation in the US and Japan are also a concern.

The International Monetary Fund (IMF) comments that the global recovery is "threatened by these growing strains and fragilities". Global economic growth is expected to be 3.3% in 2012 and 3.9% in 2013 which is 0.7% and 0.6% lower than expected in September 2011 (figure 1).

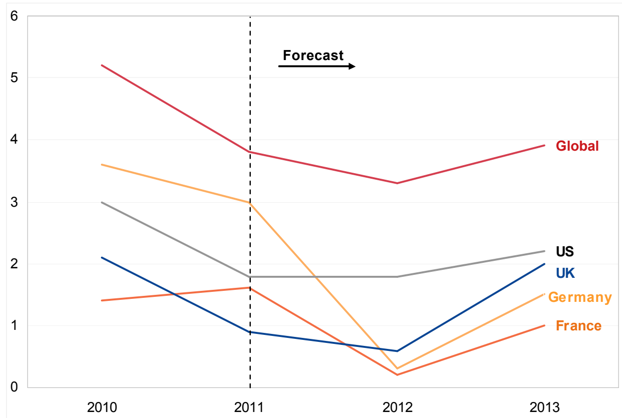
Growth expectations for advanced economies and emerging and developing economies have been reduced by a similar amount. Advanced economies are now expected to grow by 1.2% in 2012 and 1.9% 2013 and emerging and developing economies are expected to grow by 5.4% and 5.9% in 2012 and 2013.

Commodity prices generally fell in 2011 due to weaker global demand. Oil prices however held up, largely due to supply side factors. As a result, global consumer price inflation is projected to ease over the next couple of years.

With these expectations it is unsurprising that monetary policy is expected to remain accommodating and interest rates are expected to remain at record low levels in a number of developed economies for some time to come (box 1).

Figure 1: Economic output projections

% change year on year



Source: IMF World Economic Outlook January 2012

Box 1: Central bank behaviour and monetary policy developments

"Monetary policy" refers to the actions undertaken by a central bank, such as the US Federal Reserve or the Bank of England, to influence the availability and cost of money and credit to help promote price stability. This can be done by influencing the price at which money is lent – either directly through bank interest rates – or more recently indirectly by injecting money directly into the economy by buying assets and reducing longer-term borrowing costs (known as quantitative easing).

The Federal Open Market Committee (FOMC) of the Federal Reserve meets regularly during the year to review economic and financial conditions, determine the appropriate stance of monetary policy, and assess the risks to its long-run goals of price stability and sustainable economic growth. A recent development is that the FOMC now publishes the future path of policy that each Committee member believes most likely to deliver outcomes for economic activity and inflation that best satisfy their interpretation of the Federal Reserve's economic objectives.

The FOMC met on the 24th - 25th January 2012 and recently published its minutes. In figure 2, the dots represent individual members' projections of the appropriate federal funds rate target at the end of each year and in the longer run.

Given their view of the economic outlook for the US, the majority judgement appears to be that an increase in the interest rate is not likely until 2014.

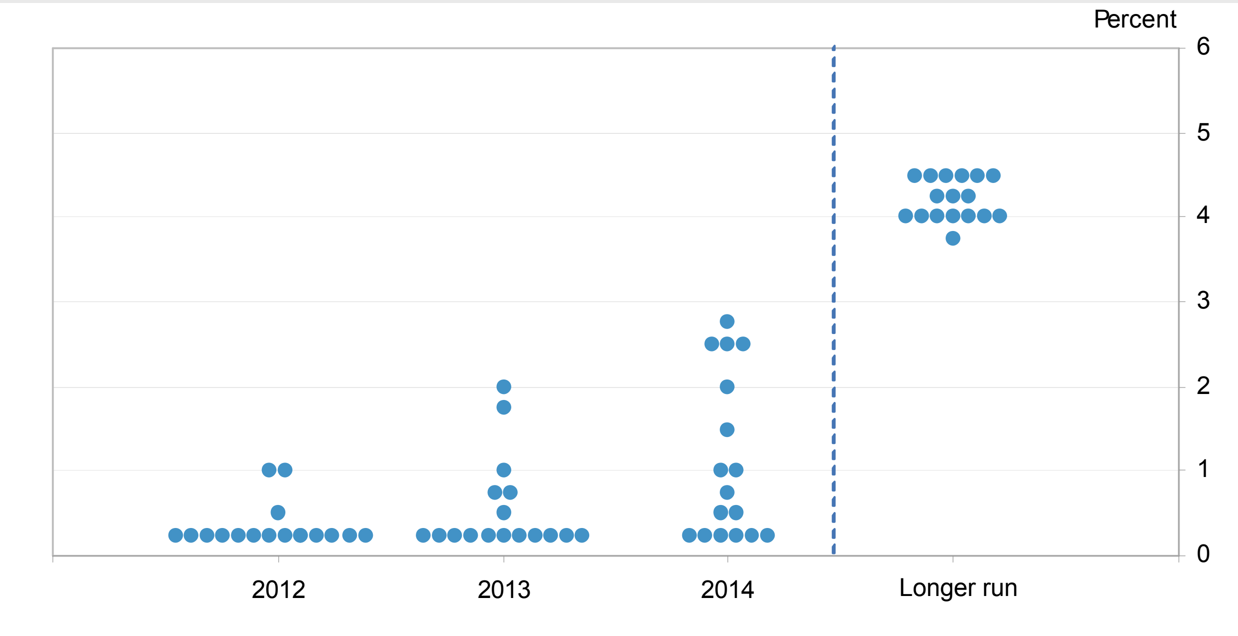
In addition, the expected size of the increase of between 1% and 2.5% by the end of 2014 falls short of their longer term expectations for the federal rate of about 4%. Together this means they expect a slow recovery with a drawn out return to full employment.

The Bank of England exists to ensure monetary stability (stable prices and low inflation) and to contribute to financial stability (detecting and reducing threats to the financial system). The Monetary Policy Committee (MPC) of the Bank of England plays a similar role to the FOMC.

It met on the 9th February 2012 and voted to maintain the bank rate at 0.5% and increase the size of its asset purchase programme by £50 billion to a total of £325 billion. The decision was based on a judgement that the weak economic growth outlook and associated downward pressure from economic slack meant that in the absence of action it was more likely than not that inflation would undershoot the 2% target in the medium term.

This also means that an increase in the Bank of England interest rate is unlikely until 2014.

Figure 2: Target federal funds rate at the end of the year (based on Federal Reserve Board Members judgement)



Source: Federal Reserve (http://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20120125.pdf)

Economic activity - finance

The ongoing financial market turmoil accompanying the sovereign debt crises in the Euro area has continued to affect financial services business optimism. If well founded, this would suggest a slower return to growth for the Island.

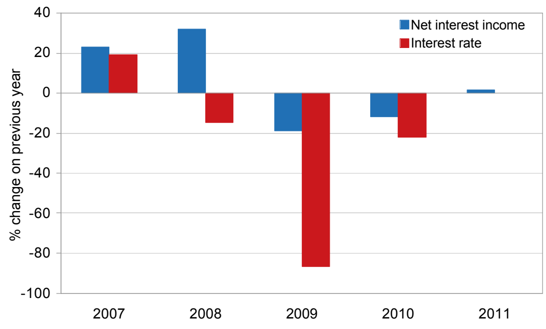
The expectation of when interest rates are expected to go up has been delayed. The US Federal Reserve Committee has recently revealed its interest rates may not increase until 2014 and the Bank of England increased quantitative easing in February (see box 1). Together these developments suggest that interest rate rises in the UK may not occur until 2014 at the earliest.

Figure 3 shows how the net interest income of Jersey banks has been affected by changes in interest rates and that only a minor improvement is expected in 2011 given the trends in interest rates. This will hold back any improvement in banking profitability although the situation may be eased slightly by a reduction in bad debt provision.

The Business Tendency Survey (BTS) provides qualitative information on ten indicators of business performance each quarter. In December 2011, business optimism continued to fall compared to the previous quarter and new business and profitability remain weak. Overall, the growth in business activity slowed consistently in 2011 (figure 4).

Finance firms still anticipate growth in future business activity, but less so than in previous surveys. Expectations about future employment trends have also weakened (see figure 11). We will know more about actual trends in employment at the end of March when the next labour market report is published.

Figure 3: Net interest income of Jersey banks

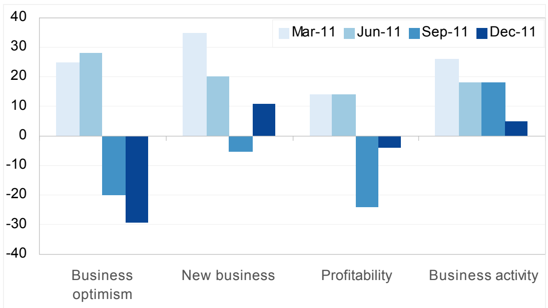


	2007	2008	2009	2010	2011*
Net interest income, £m	1,253	1,653	1,338	1,183	1,200
B of E interest rate, average %	5.5	4.7	0.6	0.5	0.5

Note: 2011 is an annualised figure based on three quarters

Source: Jersey Financial Services Commission Banking Statistics and Bank of England Statistics

Figure 4: Financial services business tendency
% net balance of respondents reporting an increase



Source: Business Tendency Survey December 2011, Jersey Statistics Unit

Economic activity – non finance

While some of the finance sector indicators became more negative in the last half of 2011, the non-finance sector has remained consistently negative across many of the business performance indicators for more than a year now and more so in the December survey (figure 5).

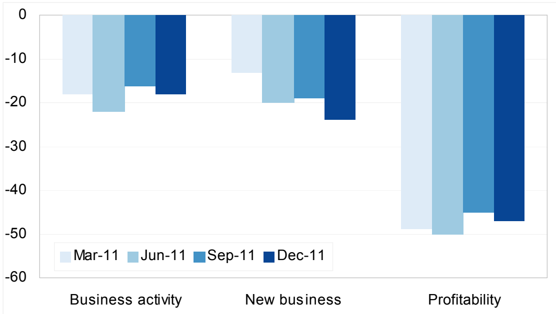
The Construction sector accounts for 10% of Jersey's total workforce and about 7% of total economic activity. The responses from these businesses were generally more negative in the last quarter of 2011 compared to earlier quarters. This would suggest that they no longer expect to see current levels of activity maintained with less future work on their books. The headline business activity indicator was the most negative seen since the first half 2011 and the new business, profitability and business optimism indicators were also significantly more negative. The business optimism and future employment indicators were the most negative levels seen to date.

The volume of Jersey retail sales fell by 5% in 2011 Q3 compared to the previous year (figure 7). This information tells us about conditions at the time, rather than what may happen in 2012 and is consistent with lower business confidence and other labour market developments at the time (see next section). Footfall on the high street is lower so far in 2012 than was the case for the same period last year.

The number of staying leisure visitors and business visitors to Jersey grew slightly (0.5%) in the first 11 months of 2011 compared to the same period in 2010. The number of staying leisure visitors from the UK fell, but this was made up by an increase in visitors from France and Germany. Another year of stability in visitor numbers in weak external markets is a positive sign after the annual declines in numbers seen up until 2008.

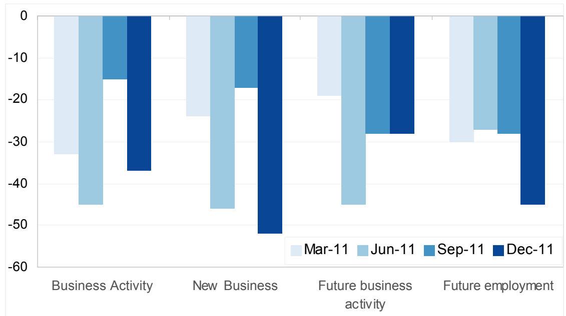
The Fiscal Policy Panel published an update to their annual report on 21 October 2011. They expected modest growth of 0 to 3% in 2011 but revised the central estimate down to -2% to 2% for 2012 and stressed that even then the risks were already more to the downside (figure 8). Unfortunately since October the euro zone crisis has continued without a successful resolution and longer term economic growth prospects have recently worsened as a consequence. This makes it more likely economic growth in Jersey will be in the lower part of the range for 2012.

Figure 5: Non-financial services business tendency
% net balance of respondents reporting an increase



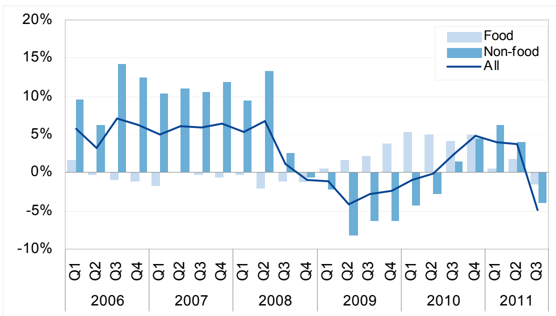
Source: Business Tendency Survey December 2011

Figure 6: Construction business tendency
% net balance of respondents reporting an increase



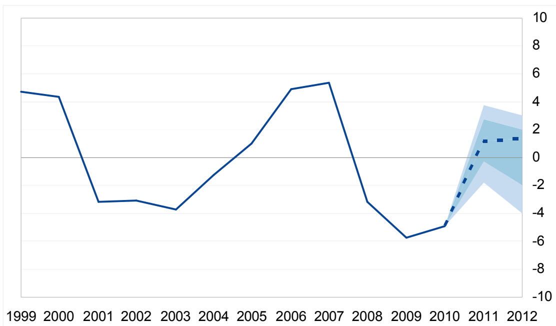
Source: Business Tendency Survey December 2011

Figure 7: Retail sales performance
Seasonally adjusted annual change in volume, %



Source: Retail Sales, Jersey Statistics Unit

Figure 8: Latest growth forecasts
Annual change in GVA, %



Source: Fiscal Policy Panel Annual Report – October 2011

Labour market

Unemployment in Jersey continued to increase during 2011. The International Labour Organisation (ILO) measure – the internationally comparable measure of unemployment – is the best indicator because it includes those that are unemployed and looking for work but not registered as Actively Seeking Work (ASW).

In the summer of 2010 the ILO unemployment rate was estimated at 3% of all economically active adults or about 1,700 people. The 2011 Census (taken end of March 2011) recorded an unemployment rate of 4.7% or about 2,600 people. This level of unemployment is relatively high compared to that seen in recent years in Jersey, but it is below that of the UK for example, where the rate is 7.7%.

The number registered as ASW (seasonally adjusted) was about 1,570 in December 2011 – up 320 on the year before (figure 9). Of particular concern is that the number of long-term unemployed (registered for more than a year) increased from 150 people to 290 people during 2011. Long term unemployment, particularly amongst young people, has large negative social and economic costs and in turn can have damaging consequences for the economy's future productive potential.

Although careful interpretation is needed in comparing trends in ASW and ILO unemployment, the trends since March would suggest that the ILO has drifted higher than the 4.7% measure in the Census.

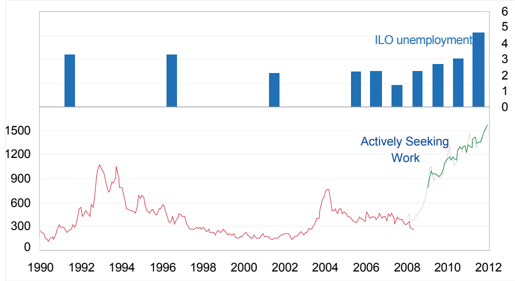
Overall, the Business Tendency Survey suggests that the labour market will remain weak in 2012 with businesses continuing to see lower employment, quarter-on-quarter and the expectation for the first quarter of 2012 is that more businesses will employ less people (figure 10). Sentiment is particularly negative in the non-financial services businesses which employ about 75% of those that work in the private sector in Jersey.

Financial services businesses reported lower employment in December 2011 and expectations about future employment have weakened further (figure 11).

Figure 9: Changes in unemployment

Upper: ILO unemployment rate

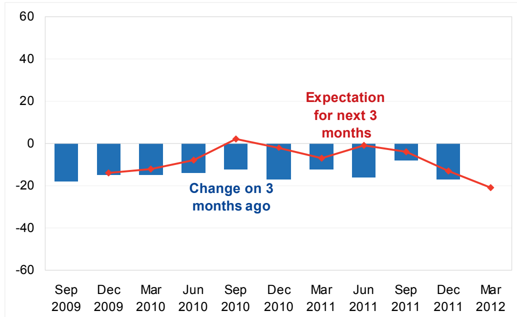
Lower: Number registered as unemployed and ASW



Source: Jersey Statistics Unit

Figure 10: Firms report continuing reductions in employment

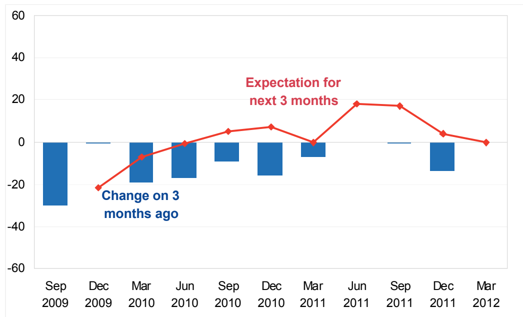
All sectors, weighted net balance, percentage points



Source: Jersey Statistics Unit

Figure 11: Financial services report a reduction in employment but are more positive about the future

Finance sector, weighted net balance, percentage points



Source: Jersey Statistics Unit

Prices and inflation

Retail price index (RPI) inflation in Jersey fell to 5.0% in December 2011 and underlying (RPIX) inflation also fell to 5.1%. The fall was a result of a large fall in fares and other travel costs but also lower rates of increase in motoring costs, fuel and light, leisure goods and lower food prices. The headline numbers continue to be impacted by the increase in GST from 3% to 5% in June 2011 which has a temporary upward effect of around 1.3-1.4 % for 12 months.

Figures 12 (a), (b) and (c) illustrate the latest forecasts for RPI, RPIX and RPIY inflation. The forecasts are based on statistical models that use information on the past behaviour of inflation to project how inflation is likely to change in the future, using expectations for variables such as indirect taxes, interest rates, oil prices and other known price increases (such as pre-announced utility prices). The forecasts are presented using the fan chart format similar to that used by the Bank of England, where each band of the fan represents a 10% probability (+/- 5% either side of the median forecast).

It is expected that RPI and RPIX will gradually fall from its current level towards 3% by 2013 (Figure 13) as the one-off effect of GST on prices drops out and commodity price pressures ease.

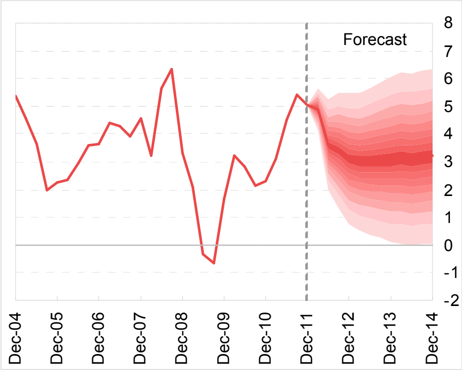
The RPI forecast for inflation is strongly influenced by when interest rates are expected to increase. They are expected to remain on hold until 2014 which means that RPI and RPIX should follow each other closely until this time.

The best measure of underlying inflation in Jersey is RPIY, because it excludes the impact of mortgage interest payments and indirect taxes which during times of significant change can have large temporary effects on the other measures of inflation.

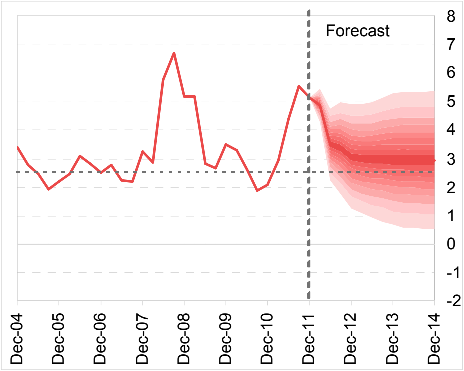
RPIY is expected to gradually fall from 3.5% to 3.1% over the year and the outlook beyond looks similar to RPIX (3.0% in 2013 and 2014) and slightly below RPI because of the impact of expected increases to the interest rate (figure 13).

Figure 12

(a) Forecast of RPI inflation
(all items)



(b) Forecast of RPIX inflation
(all items, excluding mortgage interest payments)



(c) Forecast of RPIY Inflation
(all items, ex. MIPS and indirect taxes)

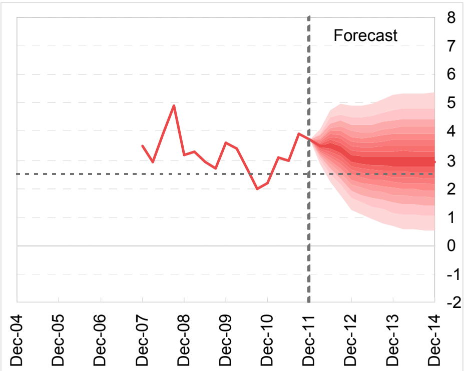


Figure 13: Table of inflation forecasts
% change on same quarter previous year

	2012				2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
RPI	4.9	3.6	3.4	3.1	3.0	3.0	3.1	3.1	3.1	3.1	3.1	3.2
RPIX	4.9	3.5	3.4	3.1	3.0	3.0	3.0	3.0	3.0	2.9	2.9	2.9
RPIY	3.5	3.5	3.4	3.1	3.0	3.0	3.0	3.0	3.0	2.9	2.9	2.9

Source: Economics Unit

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