Jersey's Fiscal Policy Panel

Deputy Susie Pinel
Minister for Treasury and Resources
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Dear Minister

Economic Assumptions

The Fiscal Policy Panel has pleasure in presenting its latest economic assumptions. The Panel is required to consider and assess what the appropriate economic assumptions should be for the development of the States' income forecasts.

These assumptions provide an update to the previous assumptions presented in March of this year and are based on recent developments both in Jersey and in the global economy. The assumptions are also informed by a number of meetings which the Panel has had in July with a range of representatives from the local business community.

The global economy remains resilient but growth prospects are becoming more uneven. In the July 2018 World Economic Outlook Update the International Monetary Fund (IMF) reiterated its forecast for global growth of 3.9 per cent in both 2018 and 2019, representing an acceleration in growth for both advanced economies and emerging and developing economies. However, the IMF noted that risks to this outlook are mounting and projections have been revised downwards for the euro area and the UK. These risks now threaten the short term as well as the medium term.

UK GDP growth is forecast to slow to 1.4 per cent in 2018 and 1.5 per cent 2019, a slight slowdown from 1.7 per cent seen in 2017. This represents a significant deceleration from the previous five years and growth is not expected to pick up significantly in the medium term, given the uncertainties presented by Brexit.

Since our last letter in March, data on Jersey have been largely positive:

- The labour market continued to strengthen in the second half of 2017, with a record high December employment figure. Total employment increased by 2.2 per cent from December 2016 to December 2017. This was driven by strong growth in the private sector and in particular a rise in full-time employment. In full-time equivalent (FTE) terms, employment was on average 2.3 per cent higher in 2017, outperforming the FPP assumption of 1.5 per cent. Social Security contribution numbers continue to see strong growth in 2018.

- The total number of people registered as unemployed and actively seeking work was 820 in June 2018. This is the lowest level since December 2008 and marks an 18 per cent fall from the same time last year.

- Overall the Business Tendency Survey (BTS) for June 2018 was encouraging with the key activity indicators showing an improvement in the current situation alongside increased optimism and confidence about future trends. Employment intentions and business activity expectations are quite strong, with employment expected to grow in both the finance and non-finance private sectors. The Panel will continue to monitor future surveys, however results can be volatile from quarter to quarter and it is not clear how much weight to put on the survey.

- Headline inflation in Jersey for the year to June was 4.5 per cent, significantly higher than the 3.2 per cent in the year to March 2018. Housing costs have been a major contributing factor, increasing by 5.1 per cent. The fastest growth was seen in fuel & light and motoring costs which both grew by around 8.5 per cent over the last twelve months, driven by an increase in global energy prices. The BTS suggests that firms are continuing to face increasing input costs.

- Recently published figures for the financial services sector suggest a mixed picture with continuing challenges in the banking sector, particularly those banks with a small footprint in Jersey. However, while the GVA of the financial sector overall declined by 2 per cent in real terms in 2017, there was strong growth in trust and company administration. Overall this is likely to mean that Jersey's economy as a whole saw little if any growth in 2017 and the Panel's estimate has therefore been downgraded from 1 per cent in March to a now essentially flat estimate. The outlook for financial services remains uncertain with some reasons for optimism, particularly in an environment of interest rate rises, but there remain significant risks in the medium and long term.

These developments taken together suggest a less positive outcome for 2017 but a somewhat more positive outlook for 2018 and 2019. In our 2017 Annual Report we highlighted that considerable uncertainty remained regarding the medium-term economic outlook for Jersey and we reiterated this in our March letter. We would continue to urge caution in fiscal planning as the core reasons for this uncertainty remain. In summary, this relates to:

- Uncertainty around Brexit and the implications for the Jersey economy which remains the biggest challenge in the immediate future.
- Uncertainty about the speed with which the Bank of England will normalise its policy rate, and the level of interest rates in the medium term. While the recent announcement of an increase in Bank Rate is welcome news for the local financial services sector, this does not mean that a return to the levels of profitability seen before 2008 is expected.
- Despite the upturn in confidence highlighted by the BTS results, competitive and regulatory challenges persist for the financial services sector in the medium-to-long term.

- Jersey's poor productivity performance over recent years has been a concern, with significant falls in the finance sector, largely driven by the low-interest rate environment, but also no measurable growth in non-finance productivity. If this poor productivity performance persists it will act as a drag on the medium-term prospects for the economy.

On the basis of these new assumptions, the Panel considers that by 2019 Jersey's economy may be slightly above its non-inflationary 'potential' level. This suggests that the States should be seeking to run a surplus in 2019. Serious consideration should therefore be given to starting to replenish the Stabilisation Fund – initially out of the surplus balance on the Consolidated Fund, especially to the extent the recent improvement in the public finances reflects one-off factors.

The Panel would also draw attention to the fact that there are a number of structural pressures in the medium term which have been identified by Treasury (as well as longer-term pressures regarding the ageing society) which will need to be addressed in the next MTFP.

We hope that you find these comments helpful in preparing the next financial forecasts. The Panel will give further consideration to the long-term trend rate of growth and degree of spare capacity in the Jersey economy as part of its pre-MTFP report next year which will aid continued analysis of the longer-term fiscal and economic trends. The Panel will also report on the draft Budget for 2019 after it is lodged in the autumn. The recommendations from the 2017 Annual Report are included at the end of this letter for your information.

Yours sincerely

Kate Barker

Kate Barker (Chair)
Francis Breedon and Richard Davies

Economic assumptions

Updated August 2018 assumptions

% change unless otherwise specified	2015	2016	2017	2018	2019	Return to trend 2020+
Real GVA	2.2	1.2	0.1	1.6	1.5	0.0
RPI	0.6	1.7	3.1	4.2	3.4	3.3
RPIY	0.6	1.7	3.2	3.8	3.0	3.0
Nominal GVA	2.9	1.9	3.3	5.4	4.5	3.0
Company profits	-0.7	0.9	-0.8	5.0	4.0	3.0
Financial services profits	-7.6	-0.6	-6.2	4.3	3.5	3.0
Compensation of employees	5.9	2.7	6.9	5.8	4.9	3.0
Employment	2.0	2.1	2.3	1.5	1.0	0.0
Average earnings	1.8	2.1	2.6	4.2	3.9	3.0
Interest rates (%)	0.5	0.4	0.3	0.6	0.8	1.0*
House prices	4.0	4.0	3.0	5.0	4.0	3.0

*Interest rate assumption for 2020 only

OUTTURNS

Previous (March 2018) assumptions

% change unless otherwise specified	2015	2016	2017	2018	2019	Return to trend 2020+
Real GVA	2.2	1.0	0.9	1.1	0.6	0.0
RPI	0.6	1.7	3.1	3.0	2.5	3.3
RPIY	0.6	1.7	3.2	2.6	2.0	3.0
Nominal GVA	2.9	1.9	4.1	3.7	2.7	3.0
Company profits	-0.7	0.9	4.1	3.4	2.3	3.0
Financial services profits	-7.6	-0.6	4.0	3.1	2.0	3.0
Compensation of employees	5.9	2.7	4.1	4.1	3.0	3.0
Employment	2.0	2.0	1.5	1.0	0.5	0.0
Average earnings	1.8	2.1	2.6	3.0	2.5	3.0
Interest rates (%)	0.5	0.4	0.3	0.6	0.9	1.1*
House prices	4.0	4.0	3.0	3.0	3.0	3.0

*Interest rate assumption for 2020 only

Change since March

Percentage point change	2015	2016	2017	2018	2019	2020+
Real GVA	0.0	0.2	-0.8	0.5	0.9	0.0
RPI	0.0	0.0	0.0	1.2	0.9	0.0
RPIY	0.0	0.0	0.0	1.2	1.0	0.0
Nominal GVA	0.0	0.0	-0.8	1.7	1.8	0.0
Company profits	0.0	0.0	-4.9	1.6	1.7	0.0
Financial services profits	0.0	0.0	-10.2	1.2	1.5	0.0
Compensation of employees	0.0	0.0	2.8	1.7	1.9	0.0
Employment	0.0	0.1	0.8	0.5	0.5	0.0
Average Earnings	0.0	0.0	0.0	1.2	1.4	0.0
Interest rates	0.0	0.0	0.0	0.0	-0.1	-0.1
House prices	0.0	0.0	0.0	2.0	1.0	0.0

Recommendations from FPP 2017 Annual Report

1. The FPP continues to believe that the profile and scale of the measures set out in the MTFP Addition and Draft Budget 2018 is broadly appropriate and advise that the remaining measures (or ones of equal value) for 2018 and 2019 need to be implemented on time.
2. The Council of Ministers is urged to ensure that a permanent programme for securing additional efficiencies in the public sector is fully embedded in all future States financial planning and in particular in time for the next MTFP. This process should identify ways in which the same services can be delivered but with fewer resources.
3. Progress has been made in meeting the Panel's previous advice regarding contingencies but there are two aspects worth giving further consideration to:
    - Ensuring that unspent contingencies that are returned to the Consolidated Fund are not used to weaken fiscal discipline and delay required permanent revenue or expenditure measures.
    - Further explanation on how the size of contingency allocations are determined and particularly so this is clearer ahead of the development of the next MTFP.
4. The Panel continues to highlight the need to prioritise delivering key capital projects on time and particularly those that will support the local economy in 2017 and 2018 (particularly in the light of the September 2017 Business Tendency Survey results) but there is the risk that this could be pro-cyclical if the economy is above capacity in the later years. However, it will be important as spare capacity continues to be used up across the economy also to be vigilant that these large capital projects do not put too much pressure on local resources and add to nascent cost pressures in the construction sector.
5. Given the scale of future capital expenditure there are a number of other risks that can be managed by:
    - Prioritising projects that demonstrably add to future productivity growth, for example in areas such as skills and infrastructure.
    - The States exerting tight control of costs to prevent projects over exceeding budgets.
    - Providing more certainty on the funding and timing of the new hospital development.

6. The improved position on the Consolidated Fund should not at this stage lead to any changes in the proposed scales and timing of measures to balance the budget – either on the revenue and/or expenditure side.
7. If the current forecasts come to fruition the Panel would expect to advise in future reports to reduce the balance on the Consolidated Fund by either transferring funds to the Stabilisation Fund or making a further repayment to the Strategic Reserve.
8. The Panel continues to support the ongoing monitoring of trends in States assets and liabilities, as set out in Council of Ministers Fiscal Framework and this should include regular assessment of trends as a share of GVA.
9. Build on the work done by the Social Security Department looking at the sustainability of the Social Security Funds in the light of the ageing population and take a whole-of-government view for a strategy to deal with the ageing society.
10. The Economic and Productivity Growth Drawdown Provision (EPGDP) should continue to identify medium-term policies that help raise productivity and increase the underlying rate of economic growth. Consideration should be given as to how the EPGDP could facilitate the adoption of new technology across all sectors in Jersey and drive significant productivity growth.
11. When considering the longer-term challenges that the Jersey economy and public finances face, this gives some direction for the key issues that need to be developed and addressed in the next MTFP:
    - **Future structural pressures**: The longer-term challenges facing Jersey make it clear that further adjustment is likely to be required during the next MTFP period. A strategy to address this should be developed that looks at what is realistic in terms of further efficiency savings (as opposed to expenditure reductions) and whether revenue-raising measures will be required.
    - **Capital expenditure**: Identifying what capital expenditure is required that is conducive to economic growth and productivity improvements. Also, how it will be financed and managed to get the balance right between preventing capacity pressures and supporting the economy. The fact fiscal policy in Jersey did not operate in a countercyclical way in 2016 is a timely reminder of how difficult this can be.
    - **Planning for surpluses**: If economic conditions over the life of the next MTFP are such that the States runs budget surpluses in any year, these should be used to replenish reserves – either the Stabilisation Fund or Strategic Reserve.