Jersey's Fiscal Policy Panel

Senator Alan Maclean
Minister for Treasury and Resources
Cyril Le Marquand House
PO Box 140
St Helier
Jersey JE4 8QT

1 March 2018

Dear Minister

Economic Assumptions

Please find attached our latest economic assumptions (figure 1 attached) which the Panel have overseen for the purpose of updating the States financial forecasts, as required under the Council of Ministers' published Fiscal Framework.

In arriving at these assumptions we have considered the developments in the Jersey economy since the publication of our Annual Report in October 2017. We have also drawn on the latest information on the UK and international economies.

In their January 2018 World Economic Outlook Update the IMF noted that global economic activity continues to firm up and that estimated growth of 3.7 percent in 2017 was slightly higher than expected. The pickup in growth has been broad based, most notably in Europe and Asia. Global growth forecasts for 2018 and 2019 have been revised upward by 0.2 percentage point to 3.9 percent, reflecting increased global growth momentum and the expected impact of the recent U.S. tax policy changes. The IMF assess that risks to the global growth forecast appear broadly balanced in the near term, but remain skewed to the downside over the medium term.

The IMF also forecast that UK economic growth will slow to 1.5% in 2018 and 2019, down slightly from 1.7% in 2017.

Since our last Annual Report there have been a number of developments in the local economy:

- GVA growth in 2016 turned out slightly higher than expected at 1.0%. However, this was primarily a result of strong growth in the rental income of private households and not a change in the underlying performance of the economy. There was growth in the non-finance sector and a decline in finance GVA as expected due to the performance of the banking sector.
- The labour market was stronger in the first half of 2017 than expected. Total employment increased by 2.2% to June 2017 compared with June 2016, driven by strong growth in private sector and full-time employment. The Panel's previous assumption was for growth of 1% for 2017 as a whole which now looks likely to be exceeded. However, growth in the number of people making social security contributions has slowed in the third quarter giving an initial indication that the pace of growth in employment in the first half of 2017 may not have been maintained into the second half.
- The total number of people unemployed (registered as actively seeking work) in the fourth quarter of 2017 is close to an 8 year low and 330 (25%) lower than at the same time a year ago. The continuous fall in unemployment since 2013 does appear to have flattened out during 2017 but this could simply be a reflection of the low level of unemployment rather than an indicator of wider economic performance.
- Overall the Business Tendency Survey (BTS) for the last quarter of 2017 was encouraging with the key activity indicators showing an improvement in the current situation alongside increased optimism and confidence about future

trends. This reverses some of the dip seen in the third quarter and it is notable that the forward looking indicators have improved the most, given the continued uncertainty facing the local economy. The improving trends were driven by the finance sector which was significantly more positive than the non-finance sector in every indicator. The indicators for non-finance were largely at similar levels to the previous quarter although business optimism and future business activity indicators improved. We will continue to monitor future surveys as results can be volatile from quarter to quarter and do not necessarily predict future performance.

- The BTS results also continue to show the fall in sterling feeding through into cost pressures with almost half of companies reporting higher input costs and a strongly negative cost indicator overall. The wholesale and retail sector seems to be particularly affected with nearly all indicators about the same or worse. There was marked deterioration in the sector's profitability with significant cost and price pressures apparent for the last 12 months.
- Headline inflation in Jersey at the end of 2017 was slightly higher than expected at 3.6% with the increase from 3.1% in the previous quarter primarily due to faster growth in food prices and housing costs. Annual inflation in 2017 therefore averaged 3.1%, higher than our previous assumption of 2.8%. The fall in sterling following the EU referendum continues to be the main reason for higher inflation in the UK and Jersey. Although all measures of inflation in Jersey are at their highest since 2012, inflation is not significantly above its long-term average given the historically low levels achieved between 2013 and 2016. In line with forecasts for UK inflation we do not anticipate the upward trend in inflation to continue and expect that inflation is likely to decline in 2018 and 2019 as the impact of weaker sterling begins to fade.

These developments taken together do not significantly alter the economic assumptions the Panel think are appropriate for use in States financial planning (see figure 1, page 5) which now include a specific, rather than trend forecast for 2019. In our 2017 Annual Report we highlighted that considerable uncertainty remained regarding the economic outlook in Jersey. This situation has not changed and has been accompanied by the recent volatility in financial markets. The key issues can still be summarised as:

- Uncertainty around Brexit and the implications for the Jersey economy which remains the biggest challenge in the immediate future.
- 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 the recent economic cycle (highlighted by another fall in productivity in 2016) which - if repeated in coming years - will act as a drag on the medium-term prospects for the economy.
- The projected ageing of the population, as in many other economies, will also bring other fiscal and economic challenges.

Overall the new assumptions combined with continued medium-term uncertainty mean that the recommendations from our 2017 Annual Report (repeated at the end of this letter for reference) remain current.

We hope that you find these comments helpful in preparing the next financial forecasts. The Panel will update its analysis of 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.

Yours sincerely

Kate Barker (Chair)

Tera Allas and Francis Breedon

Figure 1: Economic assumptions
% change unless otherwise stated

	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

August assumptions

	2015	2016	2017	2018	2019	Return to trend 2020
Real GVA	2.2	0.2	1.2	0.6	0.0	0.0
RPI	0.6	1.7	2.8	2.4	3.3	3.3
RPIY	0.6	1.7	2.8	2.4	3.0	3.0
Nominal GVA	2.9	1.9	4.0	3.0	3.0	3.0
Company profits	-0.7	0.9	3.9	2.9	3.0	3.0
Financial services profits	-7.6	-0.6	4.0	2.4	3.0	3.0
Compensation of employees	5.9	2.8	4.0	3.0	3.0	3.0
Employment	2.0	2.0	1.0	0.5	0.0	0.0
Average earnings	1.8	2.1	3.0	2.5	3.0	3.0
Interest rates (%)	0.5	0.4	0.2	0.3	0.4	0.5
House prices	4.0	4.0	3.0	3.0	3.0	3.0

Change

	2015	2016	2017	2018	2019	2020
Real GVA	0.0	0.8	-0.3	0.6	0.6	0.0
RPI	0.0	0.0	0.4	0.7	-0.8	0.0
RPIY	0.0	0.0	0.5	0.2	-1.0	0.0
Nominal GVA	0.0	0.0	0.2	0.8	-0.3	0.0
Company profits	0.0	0.0	0.2	0.5	-0.7	0.0
Financial services profits	0.0	0.0	0.0	0.7	-1.0	0.0
Compensation of employees	0.0	-0.1	0.1	1.1	0.0	0.0
Employment	0.0	0.0	0.5	0.5	0.5	0.0
Average Earnings	0.0	0.0	-0.4	0.5	-0.5	0.0
Interest rates (%)	0.0	0.0	0.1	0.3	0.5	0.5
House prices	0.0	0.0	0.0	0.0	0.0	0.0

OUTTURNS

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.