Economic Outlook | December 2012

States of Jersey
Economics Unit

HEADLINES

- *The global economy has weakened further this year and ongoing uncertainty in the euro area and US has led the OECD to revise down its forecasts for next year and state that a major contraction cannot be ruled out. If the US cannot prevent the "fiscal cliff" it faces (see Box 1) then US and global growth will be cut further.*
- *Overall trends in the local economy have deteriorated since the crisis in the euro area took hold. While there are some signs of stability returning to the economy, overall there is still no clear indication of sustained improvement in local economic conditions. This is unsurprising given the external global environment.*
- *Inflation is expected to fall slightly further in the final quarter of this year although it is anticipated to increase again slightly at the beginning of 2013 due to the announced increase in electricity prices and the increases in impôt duties agreed in Budget 2013. In 2014 all measures of inflation are expected to remain between 2.8 and 3.0 per cent.*

INTERNATIONAL ECONOMY

The global economic recovery has weakened somewhat in 2012, with global growth anticipated to be around 3 per cent for the year – considerably slower than in the first two years of the recovery. There has been a slow-down in both advanced economies and in emerging/developing economies, but the latter continue to grow at a much faster rate. For the OECD group of nations, quarter 4 of 2012 is expected to record the slowest quarterly rate of growth for over three years.

The factors acting as a drag on growth continue to be unsustainable public debt levels and the resulting fiscal consolidation, plus a weak financial system and private sector deleveraging. Concerns remain over the ability of policy makers to control the ongoing crisis in the euro area or to break the political deadlock over fiscal policy in the United States (see Box 1 below). On this basis, the risk of a major contraction cannot be ruled out.

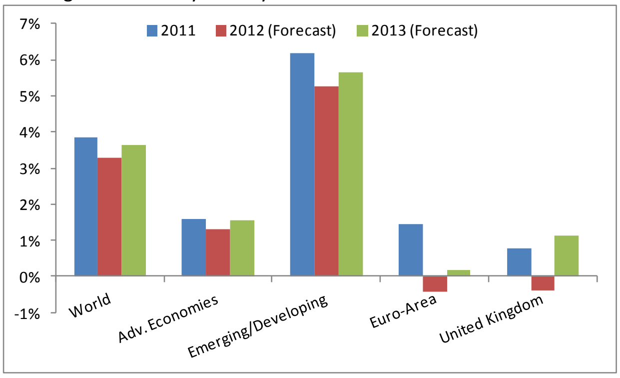
Whilst the majority of the major economies have continued to grow, this has not been the case in Europe, with further difficulties in the smaller periphery countries as the economies of Greece and Portugal are expected to record large negative growth rates in 2012. However, it is the performance of the larger economies of Spain and Italy which are likely to cause the economy of the euro area to contract overall in 2012. While Germany is anticipated to continue to grow, this has slowed and is more than offset by the contraction in Italy alone.

Looking to future years, continued retraction in Greece, Portugal, Spain and Italy combined with a further slowdown in Germany means that the euro area is expected to remain in recession into the first quarter of 2013. Recent forecasts by the OECD suggest that the economy of the euro area will pick up only slowly during 2013 and into 2014.

The United Kingdom has emerged from recession, growing by 1 per cent in quarter 3, after three quarters of contraction. Whilst output is expected to decline over 2012 as a whole, the economy is expected to return to growth in 2013 and 2014, albeit at a slow rate.

UK Government debt remains high which requires continued fiscal consolidation and therefore monetary policy is likely to remain accommodating for the foreseeable future. Continuing difficulties in the euro area are likely to continue to act as a drag on growth and any worsening of the situation will reduce the likelihood that recovery in the UK will quicken.

Figure 1: Economic output projections
% change in real GDP year on year



Source: IMF World Economic Outlook October 2012

Box 1: The United States "Fiscal Cliff"

The "fiscal cliff" refers to a series of tax increases and spending cuts which are scheduled to be implemented in January 2013.

The spending cuts were put in place in response to the debt-ceiling crisis of 2011. Legislation was passed which put in place automatic, across the board cuts which would be implemented in the event that the US political system was unable to agree on an alternative plan to reduce the federal deficit.

The tax increases primarily result from the scheduled expiry of a number of temporary tax cuts implemented by George Bush in 2001 which have twice been extended - in 2010 and 2012. The two extensions also put in place additional temporary tax cuts and increased benefits, intended to act as a stimulus to the economy.

In total, the spending cuts and tax rises will amount to fiscal tightening of approximately $700 billion in 2013 – equivalent to approximately 20 per cent of federal government spending. The spending cuts amount to $120 billion while the tax increases make up a further $590 billion.

The Congressional Budget Office (CBO) estimate that should the deficit-reduction proceed, real GDP would fall by 0.5 per cent in 2013 and unemployment would grow to 9.1 per cent. However, the CBO state that current policies would ultimately lead to an unsustainable level of government debt and at some point there would be a requirement for people to pay significantly more taxes or accept substantially less in government benefits and services (see figure 2c).

The CBO has therefore modelled an alternative scenario which would see the deficit $395 billion larger than under the fiscal cliff. Under this scenario, unemployment and GDP growth would both remain around the 2012 rates (see figure 2a).

The ratings agency Fitch has considered what impact the fiscal cliff might have for global growth. They estimate that global growth would at the very least be halved in 2013, with the potential for stress in the US financial sector and asset markets to reduce this further.

Since the recent Presidential election, policy makers have been attempting to find a compromise which can prevent the economy slipping back into recession but have some impact on reducing the deficit. The Democrats have proposed raising taxes on those earning more than $200k, followed by cuts to entitlements/benefits in 2013. Many Republicans have publically rejected this, favouring a combination of cutting benefits and reducing tax deductions.

The IMF have urged policy makers to act quickly to deal with the fiscal cliff as even a short period of fiscal contraction could cause substantial damage due to the uncertainty it creates. The IMF believes that simply postponing the problem would also cause uncertainty.

The impacts have already begun to be felt. The Federal Reserve has reported that planning by small businesses is being affected due to uncertainty over tax policy. This is likely to result in a slowdown over quarter 4 as businesses postpone investment.

Figure 2a: Economic indicators in 2013 under fiscal cliff scenario (red column) and alternative scenario (blue column)

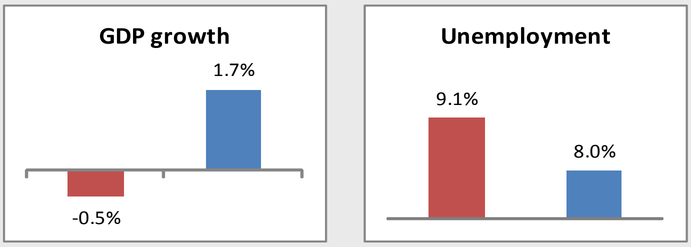


Figure 2b: Composition of fiscal cliff as a percentage of GDP

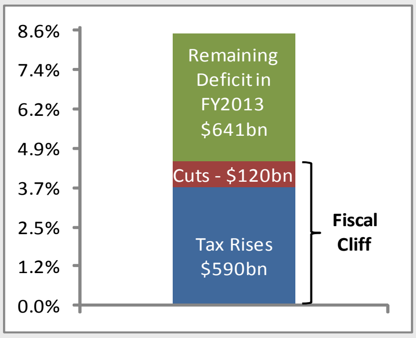
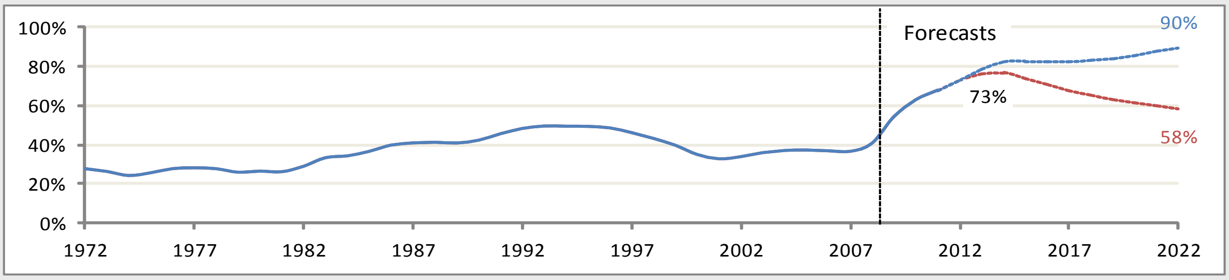


Figure 2c: Path of federal debt as a proportion of GDP under fiscal cliff scenario (red dotted line) and alternative scenario (blue dotted line)



Source: United States Congressional Budget Office, IMF estimates

LOCAL ECONOMY

Economic activity - finance

Gross value added data for 2011 show that the finance sector appears to have stabilised - remaining relatively flat in real terms after three years of significant decline. Whilst the Survey of Financial Institutions showed that there had been an 80 per cent increase in net profits in 2011, the gross operating surplus measure of profits which is used to calculate gross value added was largely flat / fell slightly in real terms.

In the Business Tendency Survey (BTS) for quarter 3, most indicators remain negative or close to zero for the finance sector. This indicates that, on an employment-weighted basis, the majority of respondents were negative about most of the indicators. Profitability and employment indicators remain strongly negative and have declined significantly since the end of 2011. Business optimism is the only indicator to have improved over 2012 to date, but remains slightly negative.

Within the financial services industry, the banking sub-sector accounts for more than three quarters of profit. Data from the Jersey Financial Services Commission (JFSC) for the banking sub-sector indicates that net interest income makes up approximately 60 per cent of banking income. Net interest income fell significantly in 2009 and has not recovered since. While the banks have successfully reduced operating expenses and bad debt provisions since 2009, profit remains significantly below the 2008 level.

Data from the JFSC suggest that net interest income has fallen slightly in the first half of 2012 but data can be volatile from quarter to quarter and the JFSC data covers only Jersey subsidiaries and therefore does not cover the entire banking sector.

Net interest income is highly sensitive to changes in interest rates. The Bank of England Bank Rate has been held at an all-time low of 0.5 per cent since March 2009 and, looking forward, market expectations indicate that it is unlikely to rise above this level until 2015, staying below 1% into 2016.

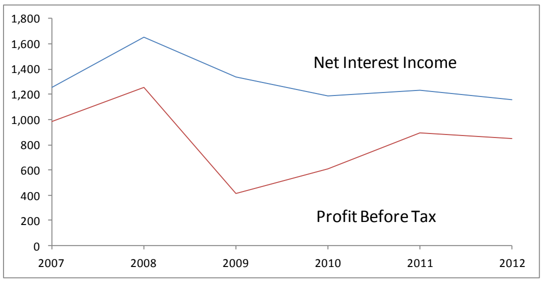
Figure 3: Finance Sector Gross Value Added

£m

Source: States of Jersey Statistics Unit

Figure 4: Banking Net Interest Income and Profit before tax

£m

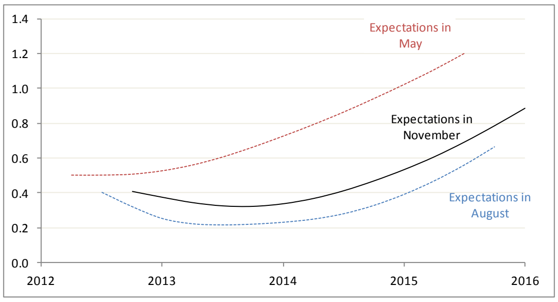


Source: Jersey Financial Service Commission

(2012 figures are annualised, based on first two quarters)

Figure 5: 2012 Market Expectations for Bank Rate

Percentage



Source: Bank of England Inflation Reports – May, August, November 2012

Economic activity – non finance

The BTS for the third quarter indicated that non-finance respondents remained negative on all ten indicators, with only new business becoming significantly less negative. Profitability remains strongly negative at a net balance of -55 per cent, indicating that a majority of respondents believe that profitability declined in the third quarter, on an employment-weighted basis.

Retail sales volumes for quarter 3 of 2012 remained flat on a seasonally adjusted basis (see figure 7). Over 2012, total volumes have fallen by approximately 1 per cent, reflecting a fall of less than 1 per cent in food volumes and a larger fall of over 2 per cent for non-food. Overall volumes have fallen 8 per cent since their peak in 2008.

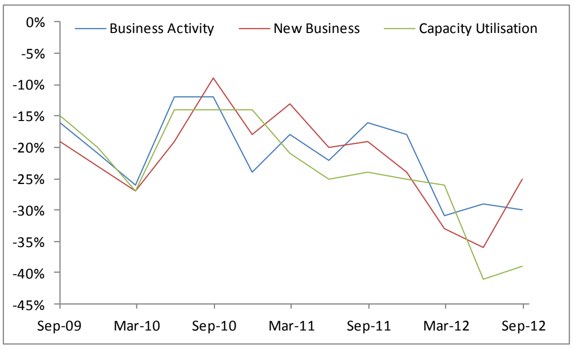
The BTS demonstrates negative sentiment on all ten indicators for the construction sector, although a number of these have become significantly less negative since the previous quarter. However, 62 per cent of construction firms (weighted by employment) felt that profitability in quarter 2 was lower than in quarter 1, against only 3 per cent reporting increased profitability. Construction firms also indicate that there is significant spare capacity in the sector at present (Figure 8).

The aggregate response of all other non-finance sectors demonstrates a negative response to each of the ten indicators. Profitability and business activity have both become significantly more negative.

Data for the first nine months of 2012 suggests a fall in tourist activity as the number of staying leisure visitors declined by more than 3 per cent on 2011 and stands more than 5 per cent below the average for the same months during 2008-2011. The number of staying business visitors during January-September has increased by approximately 1 per cent.

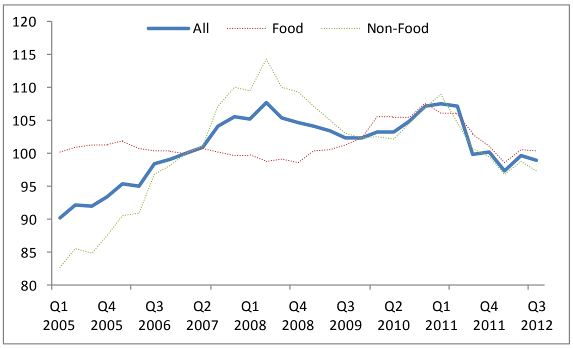
House prices in quarter 3 fell back to a similar level to that seen in 2011, having recorded an upward fluctuation in the second quarter of 2012. The volume of sales has fallen 8 per cent compared to the same quarter of 2011.

Figure 6: Non-financial services business tendency
% net balance of respondents reporting an increase



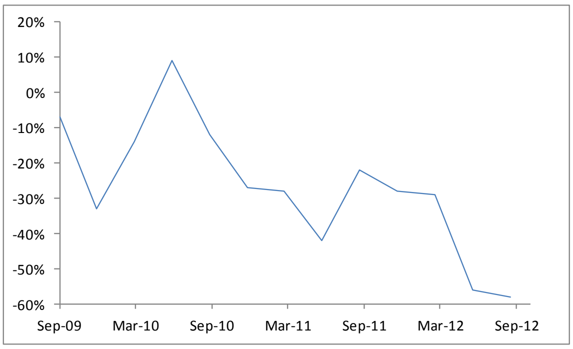
Source: Business Tendency Survey September 2012

Figure 7: Retail Sales 2005 - 2012
Seasonally Adjusted Volumes (Q2 2007 = 100)



Source: Retail Sales Quarter 3 2012

Figure 8: Construction Capacity Utilisation
% net balance of respondents reporting an increase



Source: Business Tendency Survey September 2012

Labour market

Total employment was 1 per cent lower in June 2012 than the record high recorded one year earlier. The number employed has therefore returned to the essentially flat levels seen in 2008-2010.

However, part-time employment is at a record high as a proportion of total private sector employment, increasing from 17 per cent of the total in 2002 to 21 per cent in 2012. Figure 9 shows that while full time employment is around the same level as ten years ago, part time employment has contributed over 2,000 additional jobs.

Unemployment, as measured by the number Actively Seeking Work, has remained high during 2012. Since the high reached in May 2012 however, the numbers have fallen by 3 per cent, on a seasonally adjusted basis.

In October 2012, 34 per cent of those registered as Actively Seeking Work were under the age of 25, and 20 per cent of the total were aged 16-19. The number of long-term unemployed peaked in February and March of this year and has remained slightly below this peak since.

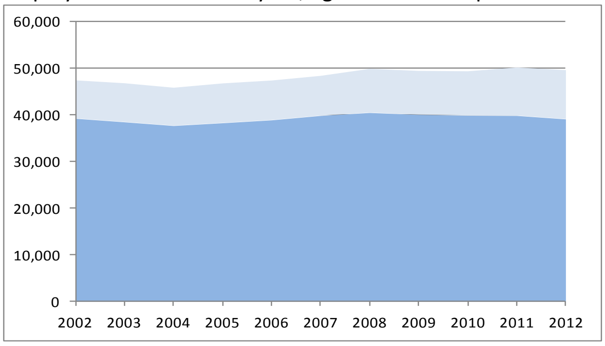
The International Labour Organisation (ILO) level of unemployment includes all those who are unemployed, whether or not they are registered as Actively Seeking Work. The most recent measure of ILO unemployment is from the Census carried out in March 2011, when it stood at 4.7 per cent or 2,569 – around double the number Actively Seeking Work at that time.

The Business Tendency Survey suggests that employment has reduced in both the finance and non-finance sectors. 40 per cent of finance firms have reported a reduction in employment in quarter 3 of 2012, with only 11 per cent of firms reporting an increase. Similarly, 33 per cent of non-finance firms have reported a decrease, against only 9 per cent reporting an increase.

Overall trends in the local economy have deteriorated since the crisis in the euro area took hold. While there are some signs of stability returning to the economy, overall there is still no clear indication of sustained improvement in local economic conditions. This is unsurprising given the external global environment described in the previous section.

The most recent growth forecasts published by the Fiscal Policy Panel (FPP) in October 2012 forecast growth of -3 per cent to 1 per cent growth in both 2012 and 2013, with risks to the downside.

Figure 9: Part-time share of private sector employment
Employment in June each year, lighter section is part-time

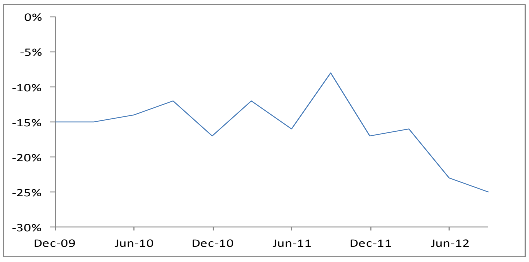


Source: Jersey Statistics Unit

Figure 10: Changes in unemployment
Left-hand Axis: Actively Seeking Work (monthly seasonally adjusted) – red line
Right-hand Axis: ILO Unemployment – blue line

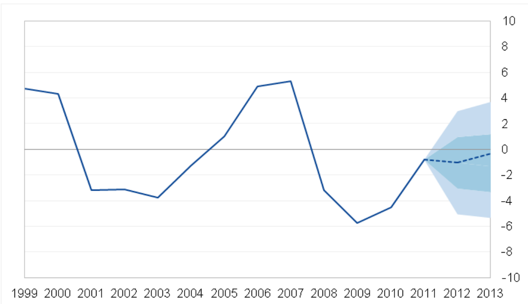
Source: Jersey Statistics Unit

Figure 11: Firms reporting increases in employment
All sectors, % net balance of respondents



Source: Jersey Statistics Unit

Figure 12: Latest growth forecasts
Annual change in GVA, %



Source: Fiscal Policy Panel Annual Report – October 2012

Prices and inflation

Retail Price Index (RPI) inflation in Jersey fell to an annual rate of 2.8 per cent in September 2012, from 3 per cent in June, with underlying inflation (RPIY) remaining at 3.1 per cent.

The fall in RPI inflation was primarily due to slower increases in clothing and motoring costs. However, motoring costs continue to rise at a rate of 4 per cent per year.

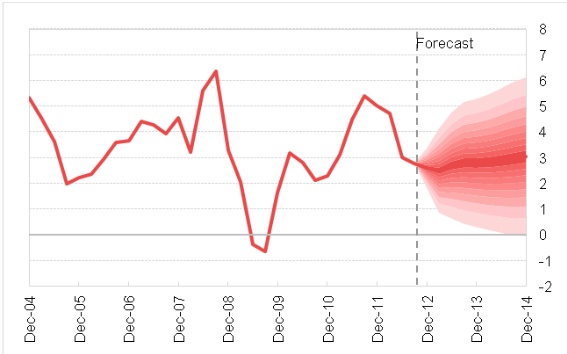
Figure 13 illustrates the latest forecasts for RPI, RPIX and RPIY inflation. The forecasts are based on statistical models that use information on the past behaviour of inflation to project how inflation is likely to change in the future. The forecast takes into account expectations for variables such as indirect taxes, interest rates, oil prices and other known price increases (such as preannounced 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 per cent probability (+/- 5 per cent either side of the median forecast).

It is expected that continuing downward pressures will result in a fall in RPI inflation in the current quarter. RPI inflation is anticipated to increase slightly again at the beginning of 2013 due to the scheduled 9.5 per cent increase in electricity prices and the increases in impôt duties agreed in Budget 2013. Underlying inflation follows a similar path, although the increase in impôts is excluded from on RPI(Y). In 2014 all measures of inflation are expected to remain between 2.8 and 3.0 per cent. There are other risks which cannot be projected by the model, such as the potential for ongoing volatility in commodity price trends or unexpected developments in oil markets.

Figure 13

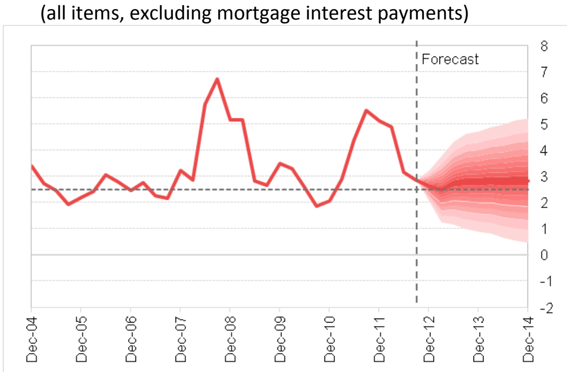
(a) Forecast of RPI inflation

(all items)



(b) Forecast of RPIX inflation

(all items, excluding mortgage interest payments)



(c) Forecast of RPIY inflation

(all items, excluding MIPs and indirect taxes)

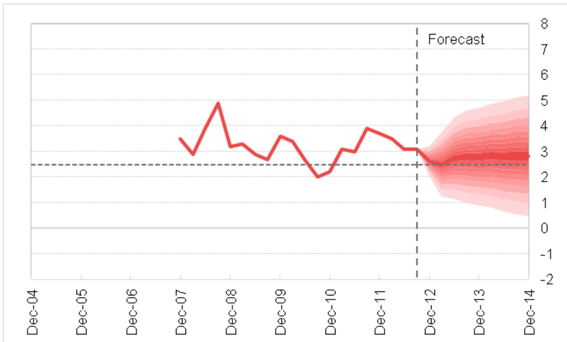


Figure 14: Table of inflation forecasts

% change on same quarter previous year

	2012				2013				2014			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
RPI	*4.7*	*3.0*	*2.8*	2.6	2.8	3.0	3.1	3.1	2.8	2.9	3.0	3.0
RPIX	*4.9*	*3.2*	*2.9*	2.6	2.8	3.0	3.1	3.1	2.8	2.8	2.8	2.8
RPIY	*3.5*	*3.1*	*3.1*	2.6	2.7	2.9	3.0	3.0	2.8	2.8	2.8	2.8

Source: Economics Unit

Actual Published Figures are in *Italics*, from Jersey Statistics Unit

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