Economic Outlook | August 2012

States of Jersey
Economics Unit

HEADLINES

- *Prospects for the global economy have weakened in the first half of the year due to ongoing issues with sovereign debt in the euro area and financial market stresses. In particular, the outlook for growth in the euro area and in the UK has grown weaker. There are significant downside risks which could see the global outlook deteriorate further.*
- *Trends in the local economy have been deteriorating since the crisis in the euro area took hold. While conditions are not deteriorating to the same extent as in 2009, the vast majority of indicators suggest that trends continue to weaken in 2012.*
- *RPI inflation has fallen from 4.7% in quarter one to 3.2% in quarter two. RPIX (excluding mortgage interest payments) has similarly fallen, to 3.0%. The primary reasons (in addition to the impact of the rise in GST falling out the figures) are slower increases in the cost of both household services and food.*

INTERNATIONAL ECONOMY

During the second quarter of 2012, prospects for the global economy have weakened. Ongoing issues with sovereign debt and financial markets have escalated further, particularly in the euro area. In July, the International Monetary Fund (IMF) revised its growth projections to take account of these stresses, resulting in a cut to the forecast for global growth from 4.1% to 3.9% for 2013, although no revision was made to forecast growth for 2012 of 3.5%, due to stronger than expected performance in the first quarter. The IMF's forecast suggests that it will take a number of years to return to pre-crisis growth levels which averaged 4.7% in the five years 2003-2007.

The IMF continues to forecast a decline in the euro area economy of 0.3% in 2012 but has reduced the 2012 projections from 0.9% growth to 0.7% growth. These forecasts are the central scenario considered by the IMF but the potential for disorderly default of a key country or a second financial crisis cannot be ruled out and would have a further significant negative impact on both the euro area and on the global economy, including Jersey.

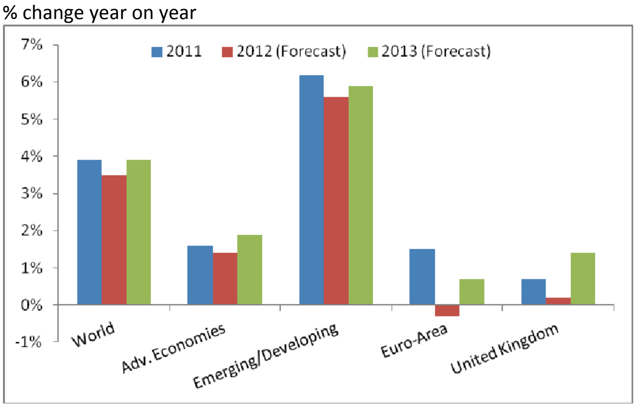
Further downside risks remain in that there are fears that the euro area will not be able to undertake sufficient action to stabilise credit conditions in the periphery and prevent contagion to larger members. In addition to questions over whether there is the political will to take sufficient policy action, there are also questions over the ability of the euro area to rescue the weaker economies, with doubts that the European Financial Stability Facility (EFSF) has sufficient remaining funds in the event of a sovereign bailout being required by either Spain or Italy. This has resulted in the EFSF itself having its credit rating outlook downgraded from stable to negative.

In addition, the IMF has significantly cut its growth forecasts for the UK. Having previously predicted 0.8% growth in 2012 before returning to 2.0% growth in 2013, the IMF has cut these forecasts to 0.2% growth and 1.4% growth in 2012 and 2013 respectively. Provisional UK GDP figures for quarter 2 of 2012 have since been released, showing that output dropped by 0.7% - significantly below the consensus projection of a 0.2% decline and marking the third consecutive quarter of negative growth. Whilst both the production and services sectors declined, construction was the main drag on growth, contributing 0.4 percentage points to the decline (see Box 1 on page 2 for further discussion).

Although part of the reason for the significant quarterly decline was the additional bank holiday and the unseasonably wet weather, the provisional figures were significantly below the consensus, which will have taken account of these factors.

Figure 1: Economic output projections

% change year on year



Source: IMF World Economic Outlook Update July 2012

Box 1: Is falling GDP a true reflection of the UK economy?

As outlined in the previous section, UK output has fallen for a third consecutive quarter and continues to lie significantly below the 2008 peak. The fall in quarter two was much steeper than analysts had expected and was in contrast to some of the other data observed in 2012 to date.

In particular, employment has seen strong growth in the first half of 2012. Figure 2 below considers the movements in employment growth and GDP growth over the last two years. The most recent employment figures demonstrate that seasonally adjusted employment among the 16+ population increased by 0.6% in the three months to May 2012. The number of full time employees has increased by a similar amount over the three months. Up to May 2012, employment has grown in seven of the last eight months, with an additional 285,000 in employment since September 2011.

Unemployment has been following a similar pattern, falling by 2.5% in the three months to May 2012, which marked the sixth consecutive monthly fall in the number of 16+ unemployed. As a result, the unemployment rate has fallen to 8.1% and has not been lower since mid-2011. This has been accompanied by a small reduction in youth unemployment, compared to the previous three month period.

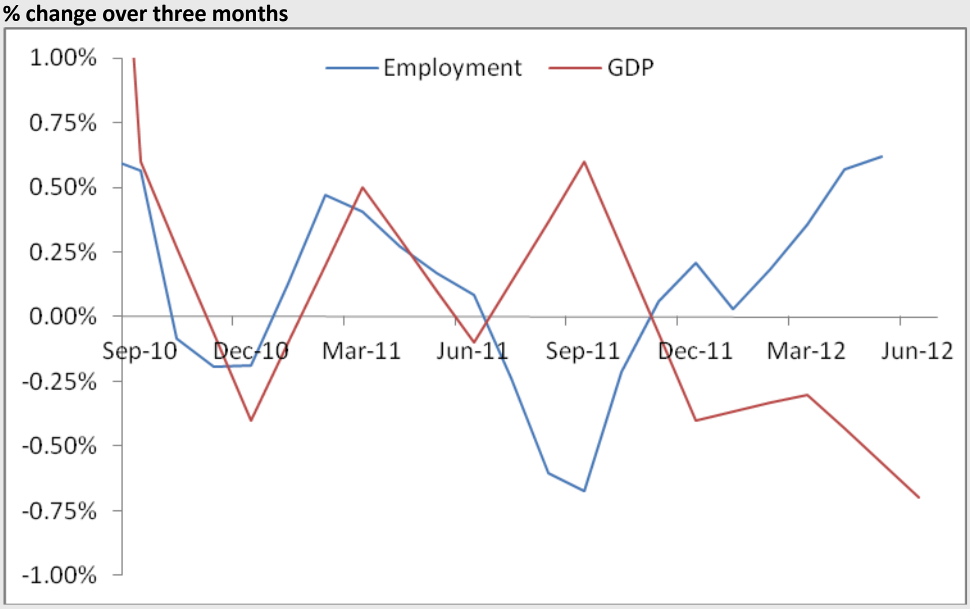
Analysts have also pointed to the Purchasing Managers Index (PMI) composite index which has suggested strong growth in the first half of 2012, to June 2012. Some have taken this to mean that preliminary GDP data for quarter 2 might be revised when more information is available.

However, beyond the labour market there has been other data which corroborates the picture painted by the GDP figures. In particular, data on real incomes suggest that the real spending power of households fell by 0.6%, meaning that price increases have now outstripped incomes over the last seven years, since 2005. The most recent falls in real income are beginning to be reflected in retail sales with seasonally adjusted volumes in quarter 2 declining by 0.7% compared to quarter 1.

Recent house price data gives further indication of a worsening in the economy, with figures from Nationwide indicating a 0.9% fall in house prices in the three months to July 2012, resulting in an annual reduction of 2.6%.

Further, more recent data from the PMI indicates that in July the UK manufacturing sector was declining at its fastest rate for more than three years, which is likely to have an impact on quarter 3 output.

Figure 2: UK movements in Employment and GDP
% change over three months



Source: UK Office for National Statistics

Economic activity - finance

The 2011 Survey of Financial Institutions (SFI) indicated net profits increased by nearly 80% to £1,110m. This increase is attributable to a small number of companies who reported large upward movements and if these effects are excluded from the data, net profit fell by 12%.

Since 2009, data has also been collected on Gross Operating Surplus (GOS) which excludes volatile income transfers from non-resident units and is an important component of GVA. 2011 saw a small 1% increase in GOS over 2010 (a decline in real terms), and the level is still significantly (16%) lower than the level in 2009. The SFI indicated that just over half (54%) of companies anticipate that profits would increase in 2012. However, this is less positive than that recorded in the 2010 SFI, when 63% of companies anticipated a rise in profits in 2011.

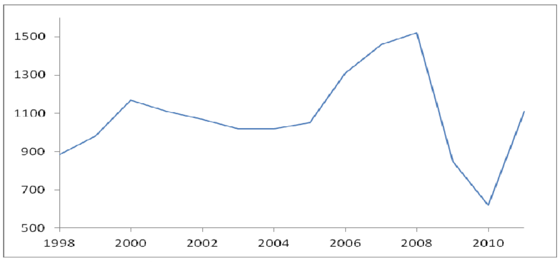
Finance sector employment costs increased by approximately 6% on 2010 and are 14% higher than 2009. Expenditure on goods and services also showed a strong increase of £70m (10%) on 2010, but only £10m of this additional expenditure was spent in Jersey.

Within the financial services industry, the banking sub-sector accounts for more than three quarters of profit. JFSC data for the banking sub-sector indicates that the primary reason for the £359m fall in operating profits between 2008 (the peak) and 2011 has been a £424m reduction in Net Interest Income (NII).Whilst the banks have successfully increased other income and reduced costs since 2008, this has not outweighed the fall in NII, which makes up approximately 60% of the banks' income.

Net Interest Income, in turn, is highly sensitive to changes in interest rates. The Bank of England Base Rate has been held at an all-time low of 0.5% since March 2009 and the consensus forecast is that it is unlikely to rise in 2012 or 2013. Data from the JFSC suggests that NII has fallen slightly in 2012Q1 but it remains to be seen whether these trends are driven by one-off factors or are an indication of overall trends this year.

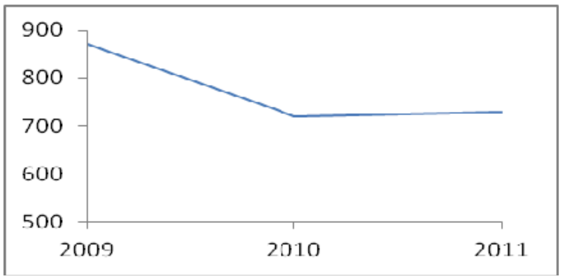
The Business Tendency Survey (BTS) for the second quarter of 2012 provides a more up to date indication of expectations in the Finance sector. Of the ten indicators polled, six are negative, indicating that the number of businesses reporting a decline on each measure outnumber those reporting an improvement. Only one of the indicators has significantly improved (by more than ten percentage points) while three have become significantly more negative. Profitability has now been negative for four quarters while business activity remains negative for the second successive quarter. Expectations for future business activity remain positive, but this is at its lowest level since September 2011.

Figure 3: Finance Sector Net Profits
£m



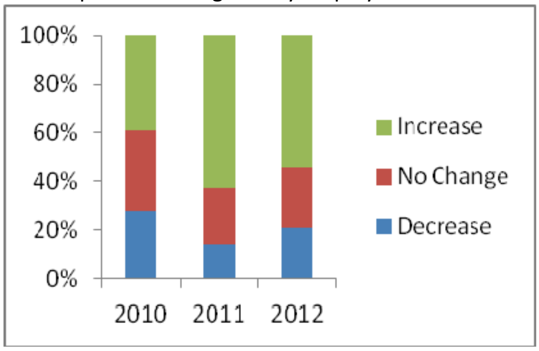
Source: Survey of Financial Institutions

Figure 4: Finance Sector Gross Operating Surplus
£m



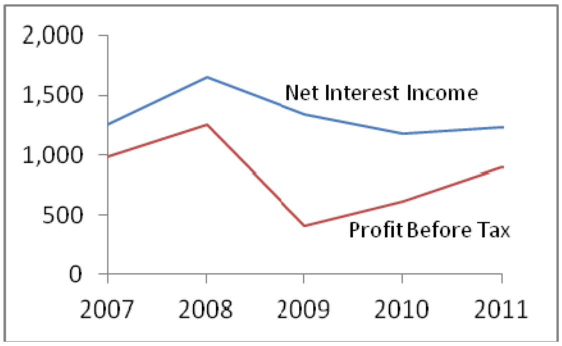
Source: Survey of Financial Institutions

Figure 5: Expectation for profits in current year
% of respondents weighted by employment



Source: States of Jersey Statistics Unit Survey of Financial Institutions

Figure 6: Banking Net Interest Income and Profit before tax



Source: Jersey Financial Service Commission

Economic activity – non finance

The BTS for the second quarter indicates that non-finance respondents remained negative on all ten indicators, of which one has become significantly more negative. Profitability remains strongly negative at a net balance of -52%, indicating that a majority of respondents believe that profitability declined in the second quarter.

Retail sales figures for 2012Q1 show a 9% fall in volume of sales compared to the same quarter in 2011. Sales volumes for the predominantly food sector have fallen by 7% whilst volumes for the predominantly non-food sector have fallen by 11%. This represents the biggest annual fall in both sub-sectors since the Retail Sales Survey was launched in April 2007. The BTS indicators show a similar picture of negative trends across the retail sector and St Helier footfall is also down year on year. These difficult conditions on the high street reflect the weak local economic conditions and continued competition from internet sales from outside the Island.

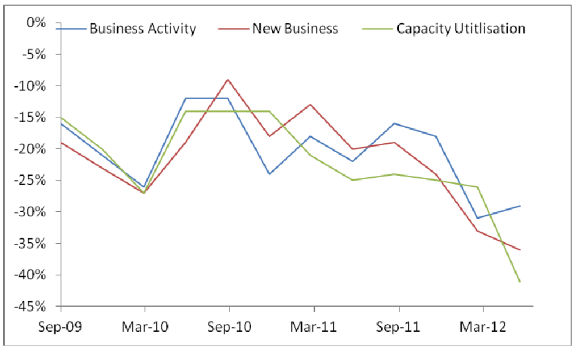
The BTS demonstrates negative sentiment on all ten indicators for the construction sector, with seven of these becoming significantly more negative. In particular, 69% of construction firms (weighted by employment) felt that profitability in quarter 2 was lower than in quarter 1, against only 4% reporting increased profitability. This was the third consecutive quarter in which this measure deteriorated and represented the most negative sentiment since the survey launched in September 2009. The largest fall has been in capacity-utilisation which now stands at a negative net balance of -56%, significantly worse than the balance of -29% in quarter one.

The aggregate response of all other non-finance sectors demonstrates a negative response to each of the ten indicators. Only one of these has become significantly more negative.

Data for the first five months of 2012 suggests a fall in tourist activity as the number of staying leisure visitors declined by 1.1% on 2011 and stands more than 8% below the average for the same months over the 2007-2012 period. Whilst data for June suggests arrivals by air have increased compared to June 2011, this has been outweighed by a fall in sea arrivals, resulting in a 0.2% decline in overall arrivals, compared to June 2011.

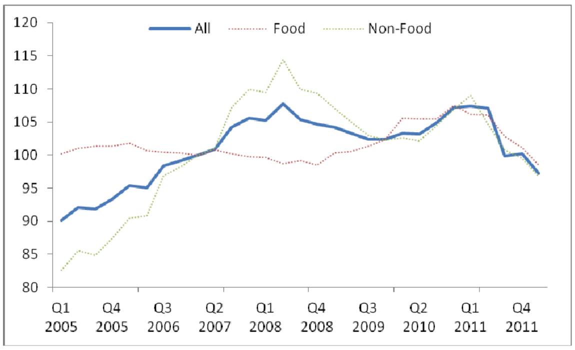
House prices reflect the deteriorating economic conditions in 2012. The mix adjusted-price for quarter one of 2012 is at the lowest level since the end of 2007 and was 5% lower than a year earlier. However, the volume of sales in quarter 1 was significantly (20%-30%) higher than any quarter of 2011, driven by an increase in sales of share transfer 1 bedroom flats.

Figure 7: Non-financial services business tendency
% net balance of respondents reporting an increase



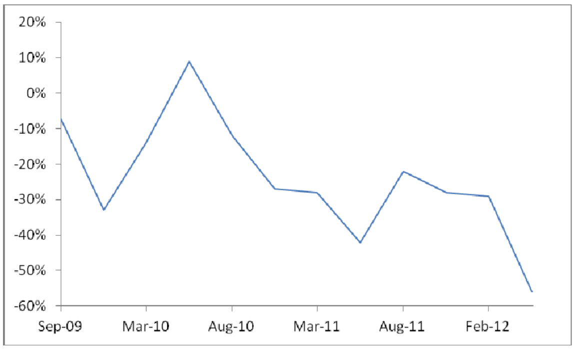
Source: Business Tendency Survey June 2012

Figure 8: Retail Sales 2005 - 2012
Seasonally Adjusted Volumes (Q2 2007 = 100)



Source: Retail Sales Quarter 1 2012

Figure 9: Construction Capacity Utilisation
% net balance of respondents reporting an increase



Source: Business Tendency Survey June 2012

Labour market

Whilst employment in Jersey at the end of 2011 was at an all time high, the number Actively Seeking Work (ASW) has increased in the first six months of 2012. By June 2012, the ASW count had increased 31% compared to the level one year before. On a seasonally adjusted basis, the most recent (June) figure was the only monthly fall during this twelve month period.

In June 2012, 30% of those registered as Actively Seeking Work were under the age of 25, with 16% of these teenagers aged 16-19. The number of long-term unemployed peaked in February and March of this year and has remained slightly below this peak for the three months since.

Whilst there hasn't been any recent update to the International Labour Organisation (ILO) measure of unemployment (since the March 2011 Census), it is likely that this measure will have increased – given the movements in the number Actively Seeking Work. The ILO measure includes all those who are unemployed, whether or not they are registered as Actively Seeking Work and is therefore likely to give a fuller picture of unemployment when the next figures are available at the end of this year.

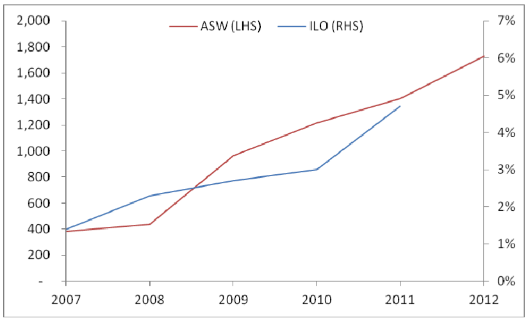
The Business Tendency Survey suggests that employment has reduced in both the finance and non-finance sectors. 41% of finance firms have reported a reduction in employment in quarter 2 of 2012, with only 13% of firms reporting an increase. Similarly, 29% of non-finance firms have reported a decrease, against only 7% reporting an increase.

Overall trends in the local economy have been deteriorating since the crisis in the euro area took hold. The majority of indicators appear to suggest that this trend is continuing in 2012.

The most recent growth forecasts published by the Fiscal Policy Panel (FPP) in October 2011 forecast growth of 0% to 3% for 2011 and -2% to 2% for 2012, with the risks primarily to the downside. Subsequently, in May 2012, the FPP stated that these risks have to some extent materialised and that evidence suggested that growth would be more in line with the downside of the previous forecast.

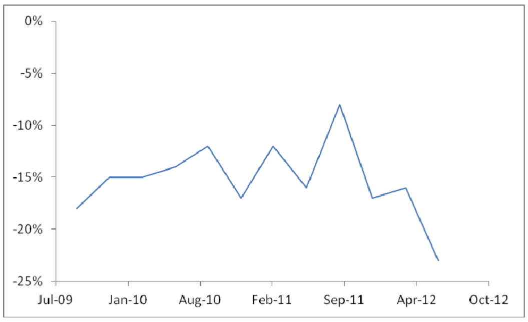
GVA data for 2011 is due to be published in late September while an updated GVA forecast for 2012 and 2013 will be included in the FPP annual report in October.

Figure 10: Changes in unemployment
Left-hand Axis: Actively Seeking Work (annual average of seasonally adjusted)
Right-hand Axis: ILO Unemployment (%)



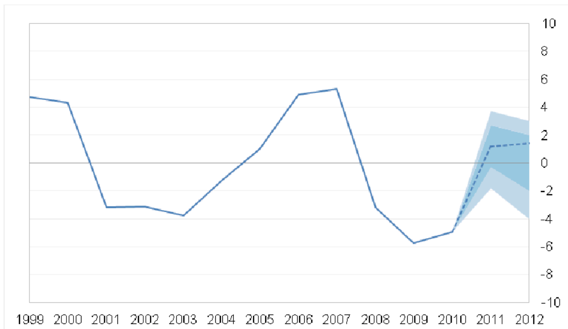
Source: Jersey Statistics Unit

Figure 11: Firms report continuing reductions 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 2011

Prices and inflation

Retail Price Index (RPI) inflation in Jersey fell to an annual rate of 3.0% in quarter 2, from 4.7% in quarter 1, with underlying inflation (RPIX) falling to 3.2%, from 4.9%.

Approximately half of the fall in inflation can be attributed to slower increases in the price of household services and household goods. Alongside these, slower increases in housing costs and leisure goods plus a fall in the price of household goods contributed most of the fall in headline inflation.

The impact of the June 2011 increase in GST from 3% to 5% has now dropped out, which is likely to explain about 1.3 percentage points of the fall in inflation.

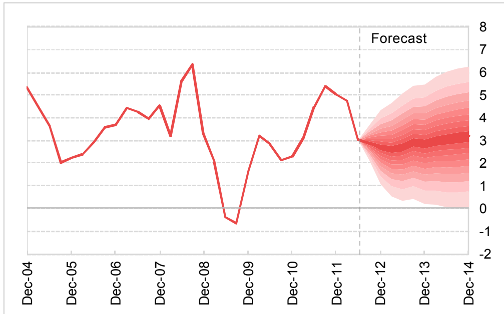
Figure 13 illustrates the latest forecasts for RPI, RPIX and RPIY inflation. The forecasts are based on statistical models that use information on the past behaviour of inflation to project how inflation is likely to change in the future, using expectations for variables such as indirect taxes, interest 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 underlying inflation as measured by RPIX and RPIY will fall continue to fall to 2.6% by quarter 1 of next year, rising slightly to 2.9% as some of the recent favourable trends are not forecast to continue. RPI will rise slightly more to 3.2% by the end of 2014, due to expected increases in interest rates.

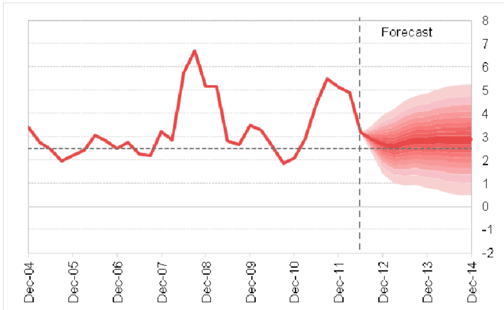
These projections may however be influenced by price increases which the model cannot predict. In particular, electricity prices are anticipated to increase due to the need to use on-island generation, rather than cheaper imports but as the impact is unclear this has not been factored into the model. Also, commodity price trends have been volatile and hard to predict in recent years.

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)

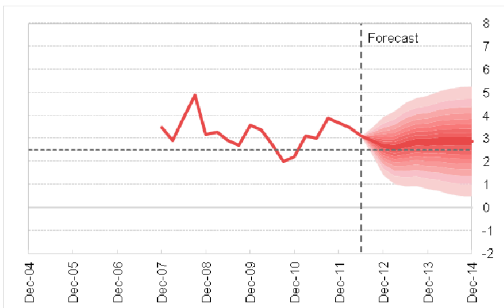


Figure 14: Table of inflation forecasts
% change on same quarter previous year

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

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

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