Economic Outlook | **February 2014**

States of Jersey
Economics Unit

HEADLINES

- Global economic growth is expected to increase in 2014 and 2015 after a slowdown in 2012 and 2013. Significant risks remain and growth is expected to be uneven and sluggish.

- Conditions in Jersey are beginning to reflect the improving global situation although there is still little evidence of sustained economic improvement. Sentiment has improved in the financial services sector and trends in the key indicators for the non-financial services sector in the Business Tendency Survey have also improved although they are still negative.

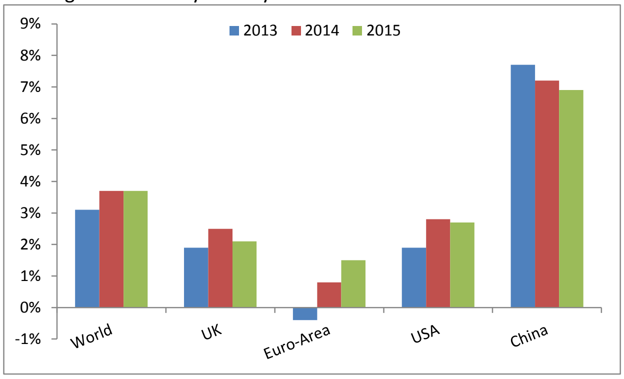
- Although the latest FPP forecasts for GVA growth this year are for it to be flat, continued improvements in the global situation and timely delivery of the significant fiscal stimulus planned for this year in Jersey will increase the likelihood of being in the upper part of the forecast range.

- Inflation is low and although it is expected to increase, underlying inflation will remain largely in line with its target in 2014 and 2015. If, as expected, interest rates begin to increase from 2015 this will put further pressure on RPI and during this period underlying inflation will be a better indicator of inflation trends.

INTERNATIONAL ECONOMY

Global economic prospects are an important determinant of the Jersey economic outlook. The global economy grew by about 3 percent in 2013, its weakest rate since the global financial crisis and subsequent world recession in 2008 and 2009. The National Institute of Economic and Social Research (NIESR) published economic forecasts for the world economy on 7 February. NIESR expect world growth to pick up in 2014 and 2015, with higher growth in the US and lower growth in the Euro area (figure 1).

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

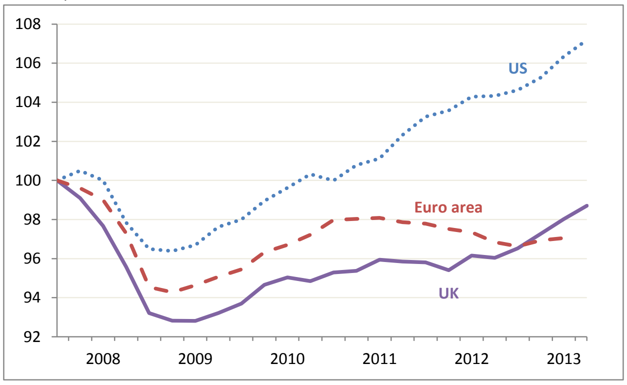


Source: National Institute Economic Review, February 2014

NIESR point out that the key risks to this outlook are that growth remains sluggish and uneven with prospects improving in the advanced economies, particularly the US but deteriorating in a number of emerging market economies, such as China. Risks to financial stability in the US and Euro area remain high. They also identify that the increased risks of that sustained low inflation could greatly complicate macroeconomic policy making across the globe.

Figure 2 shows that the UK economy initially declined much quicker than either the US or Euro area and subsequently began to recover much slower. In 2012 and 2013, the UK overtook the Euro area whose output remained fairly flat. The most recent estimates of GDP in the UK are 1% lower than quarter 1 of 2008, whilst the Euro area is about 3% lower and the US 7% higher.

Figure 2: Quarterly index of GDP for the UK, Euro area and US
2008 Q1 = 100



Source: OECD quarterly GDP volume index (SA)

NIESR's economic growth forecasts are for the UK to grow by about 2% in 2014 and 2½% in 2015, driven by consumer spending supported by buoyancy in the housing market. This would take the UK's output in 2014 above the level it was in 2008.

Box 1: The Bank of England's forward guidance

In August 2013, the Monetary Policy Committee of the Bank of England (MPC) broke new ground in UK monetary policy. It issued forward guidance linking monetary policy to future economic developments – in particular keeping interest rates the same at least until the unemployment rate falls to 7%. What this entails needed careful explaining with the Committee stating:

> *"The MPC anticipates that it will be appropriate at a minimum to maintain the current stance of monetary policy at least until the LFS headline measure of the unemployment rate falls to 7%, provided that such an approach remains consistent with meeting the inflation target in the medium term. … the 7% unemployment rate is set as a 'threshold', not a 'trigger': that is, reaching the threshold will not automatically result in a rise in Bank Rate. Instead, the MPC will reassess whether or not to raise Bank Rate above 0.5% in light of its assessment of the economic outlook."*

The MPC were clear that they believed that explicit policy guidance can enhance the effectiveness of monetary stimulus in three ways:

1. It provides greater clarity regarding the MPC's view of the appropriate trade-off between the speed with which inflation is returned to the target and the support given to the recovery.

2. It reduces uncertainty about the future path of monetary policy as the economy recovers.

3. It delivers a robust framework within which the MPC can explore the scope for economic expansion without putting price stability and financial stability at risk.

However, the financial markets took some convincing and the initial reaction was that longer-term interest rate expectations increased and sterling strengthened.

A more rapid reduction in unemployment than the Bank expected also sowed further confusion as to what forward guidance meant. In February 2014, the unemployment rate fell close to 7%, two years sooner than the Bank of England expected. This caused concerns and uncertainty about when interest rates would rise - something the policy explicitly aimed to avoid.

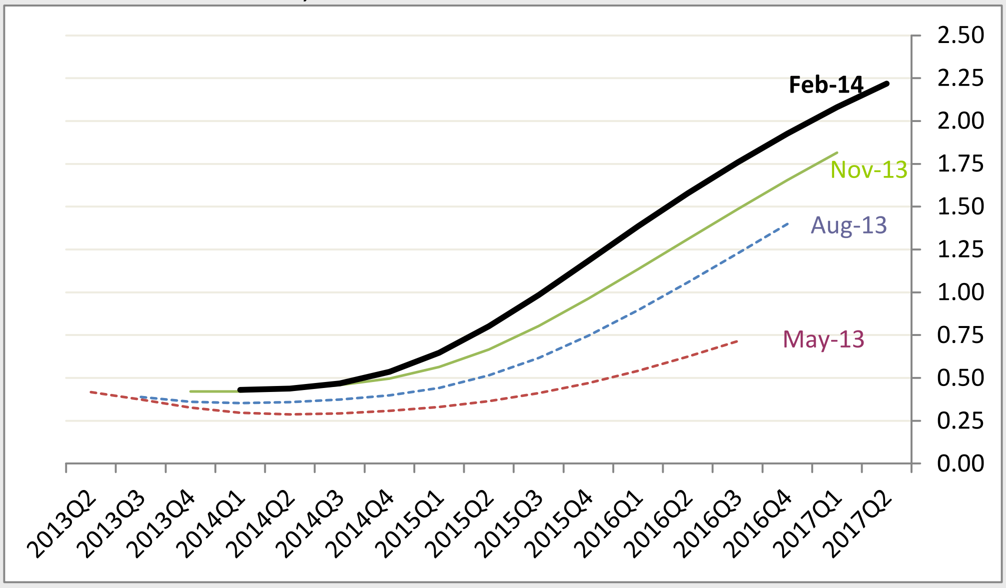
In response, the Bank of England revised its forward guidance policy in early February to include a broad range of economic indicators which measure spare capacity in the economy (see their Inflation Report February 2014).

The Bank of England clarified that the interest rate may need to remain at low levels for some time to come as although the UK economic recovery is gaining momentum, there is still spare capacity in the economy and inflation forecasts suggest that it will not breach the inflation target.

The forward market interest rate expectations are for interest rates to increase slowly from Q2 2015 reaching 2% by 2017. However, the Bank of England does not forecast interest rates and these figures should not be interpreted as such.

The market's expectations of interest rate rises have increased since this time last year. There is still uncertainty though, because the Bank of England has made it clear that more spare capacity in the economy needs to be taken up before rates will rise. It is possible that it will take longer than the market currently expects for interest rates to rise again.

Forward market interest rates, %



Source: Bank of England Inflation Reports

LOCAL ECONOMY

Economic activity – overall and finance

In 2012, economic activity in Jersey fell by 4% in real terms, representing the fifth annual fall in a row (figure 3 – purple line). The Gross Value Added (GVA) of the financial services sector has fallen by more than 30% since 2008. The main reason was a fall in banking profits which have been heavily influenced by interest rates falling to historic lows. While this has clearly had real impacts on the local economy, it is important to look at other underlying trends in GVA.

Looking at GVA without finance profits provides a different picture of our underlying economic conditions (figure 3 – red dotted line). This shows a more gradual fall in economic activity since 2008. Similarly, the GVA of our non-finance sectors (blue dashed line) also shows a more gradual rise and fall in economic activity over the last economic cycle.

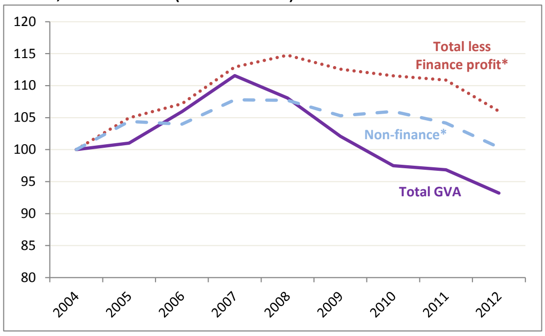
In November 2013, the Fiscal Policy Panel (FPP) forecast economic growth of between -2 and 2% in 2013 and -2 and 3% in 2014 (figure 4). This was based on the latest surveys reporting an improvement in local conditions in 2013, real earnings growth in 2013 and the improving performance of the advanced economies.

The FPP emphasised the longer-term outlook is clouded by continued weak productivity performance across the economy; the continued regulatory and competitive pressures on financial services and the future impact of the ageing society.

The Business Tendency Survey (BTS) provides qualitative information on ten indicators of business performance each quarter. The indicators have generally become more positive for the finance sector during 2013 with the future business activity, business optimism and profitability indicators improving the most (figure 5).

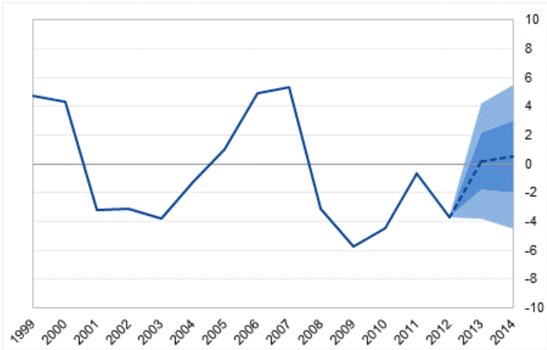
However, it will take time for these trends to feed through into improved economic activity. The Jersey Financial Service Commission's banking statistics show that banking deposits have continued to fall in 2013. However, the net asset value of funds under management was higher in Q3 2013 than a year ago.

Figure 3: Economic output (GVA)
Index, real terms (2004 = 100)



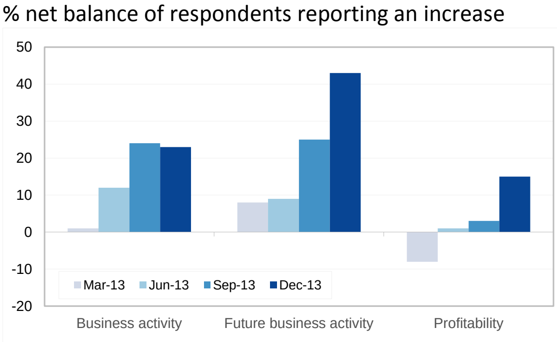
Source: Statistics Unit and Economics Unit calculations
* excludes rental activity

Figure 4: Latest growth forecasts
Annual change in GVA, %



Source: Fiscal Policy Panel Annual Report 2013

Figure 5: Financial services business tendency
% net balance of respondents reporting an increase



Source: Business Tendency Survey Q4 2013

Economic activity – non finance

A smaller proportion of non-finance firms reported deteriorating conditions in 2013. Eight of the ten indicators for non-finance businesses improved significantly during 2013 with business optimism, business activity and new business improving the most. The profitability indicator is still strongly negative, although it did improve slightly in 2013.

Conditions in the construction industry are going to be important in the future, given the States' plans to increase spending on major building and capital projects. At the moment however, conditions remain weak. Construction GVA has fallen by almost £20m since 2008 (figure 7) whilst employment has fallen by 6% (310 jobs). Survey data suggest that spare capacity in construction increased during 2012 although this was partially reversed towards the end of 2013 (figure 8).

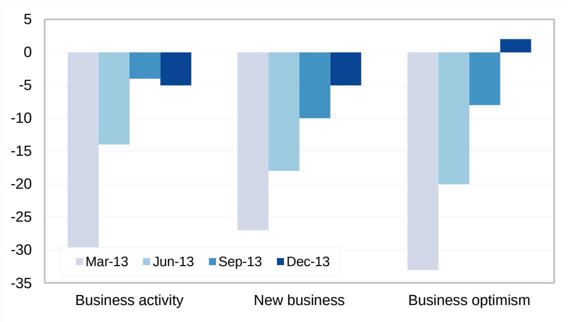
Perhaps linked to States announcements on capital projects, the sentiment of construction firms has improved over the last year. In the last quarter of 2013, the business optimism and future business activity indicators improved significantly making them positive for the first time in at least four years, since the survey began. However, the profitability indicator remains negative.

Tourism GVA (hotels, restaurants and bars) increased by 3% in 2012. In 2013, almost 1.1 million people arrived in Jersey by air and sea, a similar number compared to 2012. The number of UK staying leisure visitors continued to fall slightly whilst the number of business visitors and continental visitors increased balancing the numbers out.

The total volume of retail sales fell by 1% in the year up to Q3 2013 (figure 9). In 2012, the total volume of retail sales also fell by about 1%, although this was largely a result of trends in the non-food retail sector. Non-food volumes tend to be affected more in a weak economy and retailers are also facing increased competition from the internet. Food volumes tend to be less susceptible to cyclical variations.

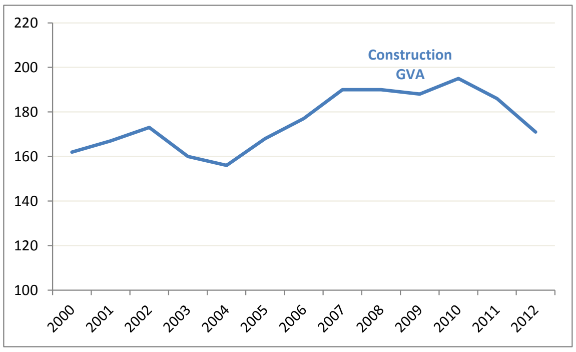
As already mentioned, part of the UK's recovery has been due to increased consumer spending. In the UK, retail sales volumes increased by about 3% in 2013 after being fairly stable since 2008 and vehicle registrations have improved. However, there is so far little indication that these trends are being repeated in Jersey although housing turnover in Q3 2013 was almost 30% higher than the previous quarter and its highest level for 6 years.

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



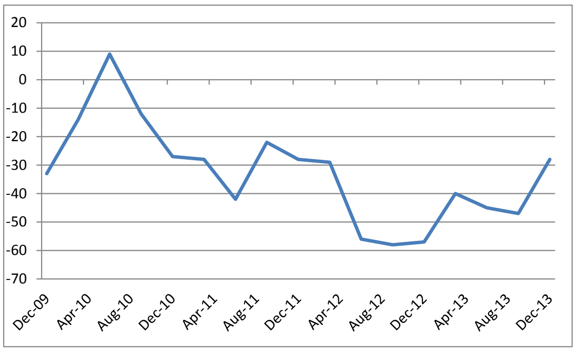
Source: Business Tendency Survey Q4 2013

Figure 7: Construction GVA
£m (real, 2003 prices)



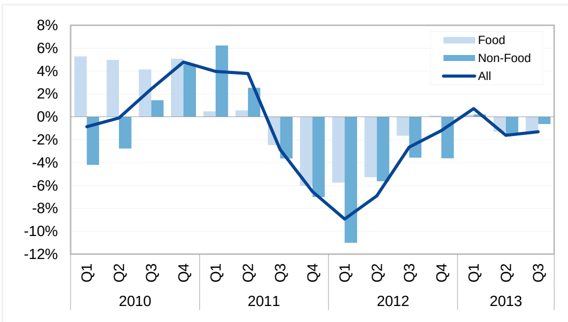
Source: Statistics Unit

Figure 8: Construction Capacity Utilisation
% net balance of respondents reporting above/below capacity (negative balance implies spare capacity)



Source: Business Tendency Survey Q4 2013

Figure 9: Retail Sales
Seasonally adjusted annual change in volume, %



Source: Retail Sales Quarter 3 2013

Labour market

Unemployment in Jersey has increased sharply over the last few years but may have stabilised in 2013 (figure 10). The International Labour Organisation (ILO) rate is the best indicator because it includes those who are unemployed but do not register as unemployed. The ILO rate was 5.7% in June 2013 which corresponds to about 3,200 people being unemployed. Although this rate is historically high for Jersey, it is still lower than the 7.1% rate of unemployment in the UK and 10.8% in France, for example.

Total employment was close to its record high at 56,290 in June 2013 – 120 lower than June 2012. Over the course of the year, private sector employment fell by 270 while public sector employment increased by 150. Full-time private sector employment was at its lowest level for seven years while part-time private sector employment was just under its highest level for at least 15 years (figure 11).

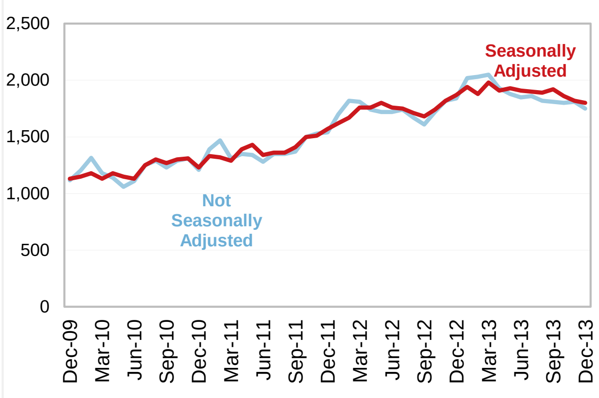
The finance sector remains the largest employer with 12,400 full-time equivalent employees (FTEs) (22% of the total) but has lost nearly 1,000 jobs since December 2008. Employment in hotels, restaurants and bars has increased by 450 (10%) since 2008 and by over 200 in the year to June 2013, with the majority being part-time posts.

Overall, the future employment indicator in the BTS showed that most (71%) businesses would keep their employment the same in the first quarter of 2014. By type of business, finance businesses were more positive about increasing employment (Weighted Net Balance (WNB) +17), while wholesale and retail businesses were more negative (WNB -20).

Average earnings grew by 2.2% in 2013 which outpaced RPI inflation (1.5%) for the first time since 2009. However, figure 12 shows average earnings have kept pace with prices since the bottom of the last economic cycle, in 2004. (The flat part of the inflation line in 2009 was due to the Bank of England lowering the interest rate to 0.5%).

Figure 10: Changes in unemployment

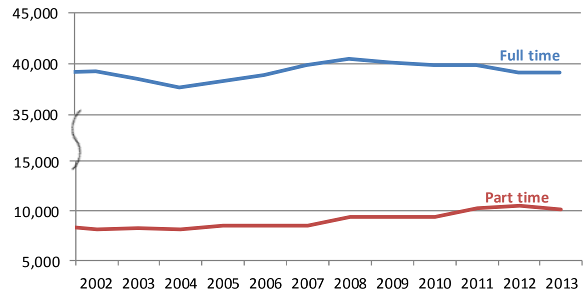
Number registered as unemployed and actively seeking work



Source: Jersey Statistics Unit

Figure 11: Private sector employment

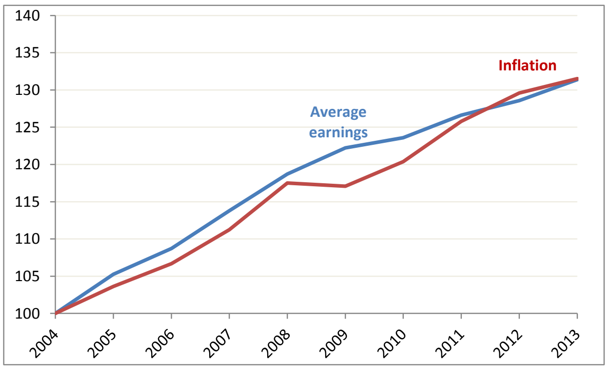
Employment in June each year, part-time and full-time



Source: Jersey Statistics Unit

Figure 12: Inflation and average earnings

Index, 2004=100



Source: Jersey Statistics Unit

Prices and inflation

The headline rate of inflation (RPI inflation) increased to 1.9% in December 2013, with underlying inflation (RPIX) increasing to 2.1%.

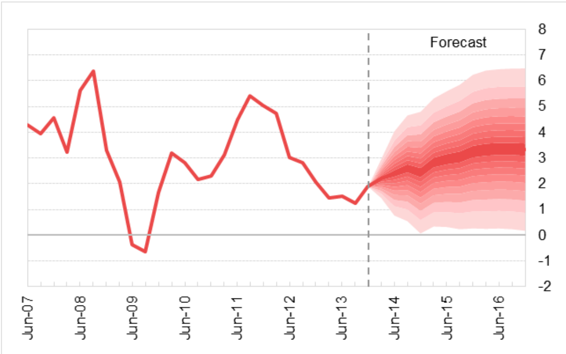
All measures of inflation remain significantly below their long-run average and underlying inflation remains below the 2.5% target. The low rate of inflation over the course of 2013 has been partly driven by a fall in motoring costs.

The latest forecasts for RPI, RPIX and RPIY inflation are illustrated in Figure 13. The forecasts are based on statistical models that use information on the past behaviour of inflation to project the future path of prices, taking into account expectations for 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% probability (+/- 5% either side of the median forecast).

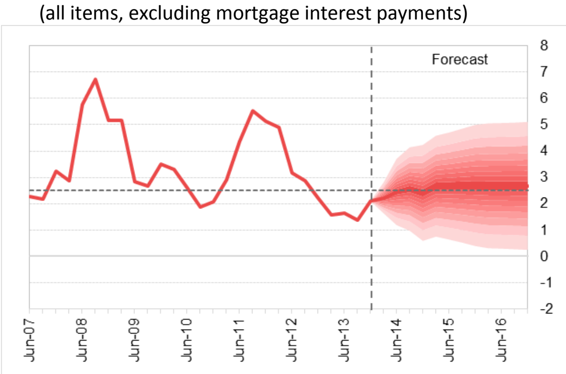
The forecasts indicate that inflation will continue to rise as the downward pressures from 2013 begin to fall out. However, underlying inflation (in terms of RPIX) is forecast to remain close to its 2.5% target throughout 2014 and 2015 with RPIY showing similar trends. The expected increases in the Bank Rate from 2015 (see Box 1 above) will see the headline measure of inflation (RPI) increase more quickly than underlying inflation which excludes mortgage interest payments. RPI inflation is expected to average 3.0% in 2015 – significantly higher than last year but below the long-run average. When interest rates are volatile underlying inflation measured by RPIX is a better indicator of inflationary trends.

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)

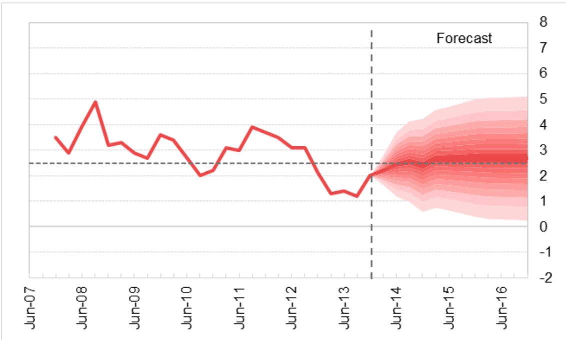


Figure 14: Table of inflation forecasts
% change on same quarter previous year

	2013				2014				2015			
	Q1	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**	**Q1**	**Q2**	**Q3**	**Q4**
RPI	*1.4*	*1.5*	*1.2*	*1.9*	2.0	2.2	2.4	2.2	2.8	3.0	3.1	3.2
RPIX	*1.6*	*1.6*	*1.4*	*2.1*	2.0	2.2	2.4	2.2	2.7	2.7	2.7	2.7
RPIY	*1.3*	*1.4*	*1.2*	*2.0*	2.0	2.2	2.4	2.2	2.7	2.7	2.7	2.7

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

CONTACT

Dougie Peedle
Chief Economic Adviser
01534 440446
d.peedle@gov.je

Mark MacGregor
Economist
01534 440432
m.macgregor@gov.je

Greg Boyd
Economist
01534 440482
g.boyd@gov.je

http://www.gov.je/EconomicsUnit