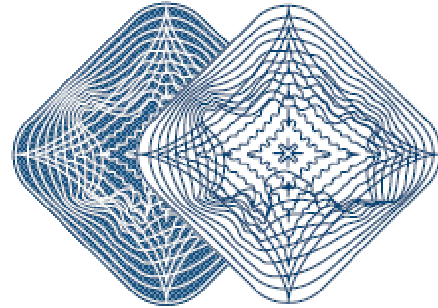

Jersey's Fiscal Policy Panel

Deputy Susie Pinel
Minister for Treasury and Resources
(copied to all States Members)

23 September 2019

Updated Economic Assumptions

Dear Minister,

The Fiscal Policy Panel welcomes the publication of the draft Government Plan 2020-23. The Panel is currently reviewing the Plan and looks forward to presenting its assessment and recommendations in its 2019 Annual Report, to be published next month. However, at this time of heightened economic uncertainty the Panel is providing an updated set of economic assumptions now, ahead of the Annual Report, to assist with planning. These are included as Annex 1 to this letter.

Jersey starts from a strong position – with the economy looking stronger in recent years than it has for a decade. Public finances remain robust, with the draft Government Plan forecasting ongoing budget surpluses and a strong net asset position. However, Jersey is vulnerable to external factors, not least the slowdown in the global economy and the economic uncertainty in the UK – Jersey's largest trading partner.

The latest forecast from the International Monetary Fund (IMF) points to a slowdown in the global economy, with growth now expected to be 3.5% in 2019 – the lowest rate of growth since 2016. The growth of the G20 group of the world's largest economies has slowed from around 4% in 2017 to less than 3% in the latest figures (when looking at

quarterly GDP compared to the same quarter a year previous). Much of this slowdown is related to increasing barriers to trade and the prospect for further tension, with the most high-profile example being the trade dispute and tariffs between the US and China. The UK economy has already slowed. In the latest quarter, UK GDP contracted by 0.2% - the first fall in output since 2012. Much of this slowdown can be attributed to ongoing uncertainty around Brexit. The prospect of the UK leaving the EU without a negotiated agreement ('no-deal') has risen significantly since our last report in March, and the Panel has considered this possibility in an additional scenario set out in Annex 2.

Further, the prospect for interest rate rises now appears more limited than in March. Policy rates have been cut in both the US and euro area in recent months and markets are not expecting any significant increase in the UK's Bank Rate over the next five years. All else equal this limits the potential for profit growth in Jersey's banking sector over the medium term as most deposits are held in sterling, dollars and euros.

Since the Panel last updated its economic assumptions, there have been several data releases locally:

- GVA of the financial services sector grew by 2% in real terms in 2018, driven by strong growth in profits. Within financial services the trust and company administration sub-sector grew at 4% in real terms with fund management growing at 3% and banking at 2%. This was the first growth in banking output since 2014.
- Total employment continued to grow at a strong rate in the second half of 2018. Growth in full-time equivalent employees is estimated to have averaged 1.4% in 2018.
- Registered unemployment appears to have stabilised, with the number registered as actively-seeking-work relatively unchanged at around 900 over the last eighteen months.
- Inflation has eased off a little from its peak but RPI inflation at 2.8% in June 2019 remains significantly above the comparable UK measure.

- Growth in average earnings slowed markedly in 2019 to 2.6%. In real terms, after inflation, earnings fell for a second consecutive year.
- Residential property prices have continued their strong upward trajectory, with average prices in June 2019 around 8% higher than a year earlier.
- Responses to the Business Tendency Survey remain broadly positive, though there has been some weakening in 2019 across all sectors.

These recent data suggest that GVA growth in 2018 may have been stronger than the Panel previously estimated. The Panel's previous (March) forecast assumed that the UK would leave the EU at the end of March, and the forecast therefore assumed a mild economic slowdown in Jersey. While Brexit did not happen as anticipated, some of this slowdown still appears to have come through so the overall forecast for 2019 is largely unchanged.

Looking forward, even without Brexit, the other external factors referred to above seem likely to put more downward pressure on Jersey's economy in 2020 than was anticipated six months ago. As a result, the Panel has downgraded its forecast for 2020. While the forecasts for 2021 and 2022 are unchanged at this stage, this is dependent on the UK agreeing a withdrawal agreement with the EU along lines as negotiated already (accepting that the full impact is not likely to be clear for several years), and on the global economic slowdown proving short-lived. Should these headwinds prove to be more persistent, the forecast for 2021 and 2022 might also need to be revised downward.

With the prospects for Jersey's economy looking somewhat weaker in the short term, this may mean that the estimated output gap – reflecting the cyclical position of the economy - does not widen as quickly as anticipated in the March report. However, at this stage recent developments do not suggest that the Government needs to start providing additional support to the economy. Next month's FPP Annual Report will consider further whether the size of the surpluses forecast in the Government Plan are appropriate.

The 'base case' economic assumptions have been set out in Annex 1 of this letter. The Panel has also been asked to produce an alternative set of economic assumptions, based on the scenario that the UK leaves the EU without a deal at some point in the next few months. This draws on the Bank of England's 'disorderly' no deal scenario and is set out in more detail in Annex 2 of this letter but broadly involves a sharp slowdown primarily because of a spike in inflation.

Given this significant uncertainty, the Panel would continue to urge that flexibility should be built into any plans. Whilst the overall fiscal stance set out in the draft Government Plan (that of continued small surpluses) seems broadly appropriate, fiscal policy should be ready to adapt to changing conditions. The Panel understands that the Government of Jersey has undertaken significant preparations for Brexit, and for a no-deal scenario, and would recommend that this is extended to developing an alternative fiscal plan in the event this may be needed.

Yours sincerely

Kate Barker (Chair)
Francis Breedon and Richard Davies

Annex 1: Base case economic assumptions

Updated base case forecast

% change unless otherwise specified	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**Trend 2023+**
Real GVA	0.4	2.5	0.9	1.0	1.3	0.8	0.6
RPI	3.1	3.9	2.8	2.4	2.6	2.7	2.6
RPIY	3.2	3.5	2.6	2.3	2.5	2.6	2.5
Nominal GVA	3.6	6.0	3.5	3.3	3.8	3.4	3.1
GOS (including rental)	-0.7	7.7	3.3	3.0	3.5	3.2	3.2
Financial services profits	-6.6	8.3	2.0	2.0	3.1	3.3	3.4
Compensation of employees	7.6	4.7	3.6	3.5	4.0	3.5	3.1
Employment	2.3	1.4	1.0	0.2	0.8	0.5	0.4
Average earnings	2.6	3.5	2.6	3.3	3.2	3.0	2.7
Interest rates (%)	0.3	0.6	0.7	0.6	0.5	0.5	0.5*
House prices	2.9	7.1	6.3	5.4	4.5	3.6	2.7
Housing transactions	6.7	7.2	7.0	3.0	3.2	2.3	1.5

*Interest rate assumption for 2023 only

Change since March

	2017	**2018**	**2019**	**2020**	**2021**	**2022**	**Trend 2023+**
Real GVA	0.0	+0.9	-0.1	-0.4	0.0	0.0	0.0
RPI	0.0	0.0	-0.3	-0.2	+0.1	+0.1	0.0
RPIY	0.0	0.0	-0.3	-0.2	+0.1	+0.1	0.0
Nominal GVA	0.0	+0.9	-0.4	-0.6	+0.1	+0.1	0.0
GOS (including rental)	0.0	+1.9	+0.1	-0.6	0.0	0.0	0.0
Financial services profits	0.0	+4.3	0.0	-0.9	0.0	0.0	0.0
Compensation of employees	0.0	+0.2	-0.9	-0.7	+0.1	+0.1	0.0
Employment	0.0	+0.4	+0.5	-0.5	0.0	0.0	0.0
Average earnings	0.0	0.0	-1.4	-0.2	0.0	+0.1	0.0
Interest rates (%)	0.0	0.0	-0.1	-0.3	-0.5	-0.6	- 0.6*
House prices	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Housing transactions	0.0	0.0	+4.0	-1.0	0.0	0.0	0.0

*Interest rate assumption for 2023 only

Annex 2: Economic assumptions for a no-deal Brexit scenario

A further set of economic assumptions has been developed, representing a scenario in which the UK leaves the European Union without a deal on 31 October 2019. This represents the 'default' under the current arrangements, unless a deal or extension is agreed by both sides before then. Should an extension be granted but the UK still leaves without a deal in early 2020, the impact is expected to be of broadly the same magnitude.

The analysis is based on the scenario presented by the Bank of England on the likely implications of a 'disorderly' UK exit from the EU[1] and the Bank's subsequent update provided to the Treasury Select Committee on 4 September[2]. The Bank of England has referred to this as being underpinned by 'a set of worst case assumptions' such as severe trade disruption and a significant fall in sterling.

The assumptions presented below assume that there is no fiscal policy response in Jersey. The Panel would expect that if appropriate and timely interventions were made then this could lessen the impact of the downturn. The assumptions do however include a monetary policy response, as rates are assumed to fall to zero to support the UK economy. This differs from the Bank of England scenario, which assumes a mechanical increase in rates in response to the spike in inflation.

% change unless otherwise specified	**2017**	**2018**	**2019**	**2020**	**2021**	**2022**	**Trend 2023+**
Real GVA	0.4	2.5	0.9	-2.5	-1.4	1.1	0.6
RPI	3.1	3.9	2.8	4.9	4.3	2.7	2.6
RPIY	3.2	3.5	2.6	4.8	4.2	2.6	2.5
Nominal GVA	3.6	6.0	3.5	2.3	2.8	3.7	3.1
GOS (including rental)	-0.7	7.7	3.3	2.8	3.3	3.4	3.2
Financial services profits	-6.6	8.3	2.0	1.5	2.6	3.8	3.4
Compensation of employees	7.6	4.7	3.6	1.9	2.5	3.9	3.1
Employment	2.3	1.4	1.0	-0.6	0.0	0.9	0.4
Average earnings	2.6	3.5	2.6	2.5	2.5	3.0	2.7
Interest rates (%)	0.3	0.6	0.7	0.0	0.0	0.5	0.5*
House prices	2.9	7.1	4.0	-5.2	2.0	2.5	2.7
Housing transactions	6.7	7.2	7.0	-10.0	5.0	3.0	1.5

*Interest rate assumption for 2023 only

When compared to the 'base case' assumptions set out in Annex 1, there are several changes. The main initial impact is expected to be an increase in inflation, driven by increases in the cost of importing due to both the anticipated depreciation of sterling and the potential for trade barriers, both tariff and non-tariff. The increase in inflation is based on the analysis by the Bank of England of the disorderly exit

[1] https://www.bankofengland.co.uk/report/2018/eu-withdrawal-scenarios-and-monetary-and-financial-stability
[2] https://www.bankofengland.co.uk/letter/2019/letter-from-the-governor-to-the-tsc-regarding-updated-brexit-scenarios

scenario. Applying these trends to Jersey, inflation under this scenario could be expected to average almost 5% in 2020 and would fall back only slowly as the exchange rate effect feeds through gradually[3].

The economic assumptions assume that the no-deal scenario does not significantly affect the competitiveness of Jersey's financial services sector in the short term. While Jersey's trade in goods with the EU may be affected, this is relatively small as a proportion of the economy.

However, in this scenario the domestically-focused sector would be expected to see a fall in demand as prices for imports rise. This includes the cost of intermediate imports, so the cost of local production will also rise in this scenario and some of this is likely to be passed on in higher prices for local goods and services – further reducing demand.

In 2020 and 2021, the fall in demand is therefore expected to hit both employment and profits in the non-finance sectors. The resultant reduction in demand for labour would see earnings contract in real terms. In nominal terms, wage growth would be only slightly lower than the base case as there will be some pressure for wages to continue to grow in light of the significant increase in the price level. This lack of response from nominal earnings will in turn prevent inflation from falling quickly.

Under this scenario, Bank Rate is expected to fall to zero in 2020. While the Bank of England has stated that "the monetary policy response to Brexit, whatever form it takes, will not be automatic and could be in either direction", individual members of the rate-setting Monetary Policy Committee have recently commented that they would most likely vote to reduce Bank Rate in the event of no-deal. This would have knock-on impacts on profits in Jersey's financial services sector, which the Panel has forecast to grow more slowly in 2020 and 2021 under a no-deal scenario but faster in 2022 as rates increase.

Under the no-deal scenario, house prices could be expected to fall by 5% in 2020 and see slow growth in 2021 and 2022. The scenario could see the number of housing transactions fall sharply in 2020 with some bounce back in 2021. This follows strong recent growth in transactions from 2017-2019, and even this sharp fall would leave the number of transactions still relatively high compared to 2016.

The impact of the reduction in profits and employment in the non-finance sector, and the increase in RPIY inflation (which is used as the deflator) would see the overall economy contract sharply in 2020 in this scenario with a further smaller contraction in 2021. GVA growth could be expected to see a small bounce back in 2022, due to a recovery in employment.

The combined impact of the no-deal scenario sees real GVA 6% lower than the base case by the end of the forecast period (2022). This is similar to the Bank of England's 'disorderly' scenario, which sees UK GDP 6% lower by 2022, when compared to the Bank's August 2019 base case.

The overall price level is expected to be 4% higher in this scenario than in the base case by 2022, while house prices could be 15% lower than they would be under the base case. Employment under this

[3] The Bank of England forecast is based on 'established empirical economic relationships' including an assumption that depreciations in the exchange rate tend to have large and protracted pass-through to consumer prices while tax changes, such as tariffs, tend to be passed through to consumer prices more quickly.

scenario is expected to be 1% lower than the base case scenario and earnings 6% lower in real terms, but only 1% lower in nominal terms.

Aggregate impact of no-deal scenario by 2022	
Real GVA	-6%
RPI	+4%
House prices	-15%
Employment	-1%
Real earnings	-6%

This forecast assumes no change to the trend growth rates assumed for 2023 onward (though the trend level of output will be lower). There is a risk however that the trend rate of growth may be lower under a no-deal scenario. For example, Jersey's finance sector might have less potential growth should a no-deal Brexit be harmful to the UK's finance sector's ability to grow in the medium-to-long term. However, the base case has only ½% annual growth in financial services trend productivity (and no growth for non-finance) and this has been primarily attributed to the potential for automation and efficiency gains, which are just as likely under a no-deal scenario. However, should a no-deal scenario unfold, the Panel will continue to monitor the risks to trend growth as the impacts become clearer.

Annex 3: Recommendations from FPP Advice for Government Plan

1. The Government of Jersey should plan to run surpluses over the 2020-2023 period – though retaining the flexibility to respond to changes in the cyclical position.

2. The Government should consider implementing revenue-raising measures or expenditure cuts now, when the economy is above trend, to increase the ability of the public finances to support the economy in a future period of below trend output.

3. In any year, the contributions to or withdrawals from the Stabilisation Fund should mirror that part of the current Budget position driven by the economic cycle and the automatic fiscal stabilisers. The Panel's forecast implies that the economy will be running around 2% above capacity next year, meaning that the addition to the Stabilisation Fund should include 0.32% of GVA in 2020 (about £16m). A further transfer is also needed to replenish the past use of the Fund for active fiscal policy through the last downturn, and ensure that the Fund is ready to provide additional fiscal support in the event of any future downturn.

4. The Government should assess potential uses of the Stabilisation Fund according to the 'three Ts' – i.e. that active fiscal policies should be timely, targeted and temporary. Should it be required over the next medium-term planning period, the Panel would advise that any active counter-cyclical support to the economy (using the Stabilisation Fund or elsewhere) should be assessed against these three criteria.

5. The Government should consider working towards a larger Strategic Reserve through a long-term programme of contributions and retaining the returns from investment, given that its objectives include insulating the economy from the sudden collapse of a major island industry.

6. The Government should ensure that any policy decisions related to the Social Security Funds consider a range of different scenarios and the impact these may have on the ability to pay deferred pensions.

7. The FPP's view is that the early part of the forthcoming Government Plan period is an appropriate time to plan an increase in the long-term care contribution, while the economy is running above trend. Consideration should also be given to whether a larger increase could be appropriate in order to provide additional flexibility regarding future increases in the rate.

8. The Government Plan will need to consider and set out how the proposed capital programme can be delivered in a way that does not put excess pressure on the limited resources available on-island.

9. It is important that the forthcoming Economic Framework focuses policy on measures that will enable improvements in private sector productivity. These should be aimed at addressing the five key drivers of productivity growth: investment, infrastructure, innovation and enterprise, skills and competition.