Jersey’s Fiscal Policy Panel

Deputy Susie Pinel
Minister for Treasury and Resources

12 August 2021

Updated Economic Assumptions

Dear Minister,

Please find our updated economic assumptions at Annex 1. These assumptions are provided for use in preparing the Government Plan 2022-25.

The context for this set of economic assumptions is one of cautious optimism that Covid-19 related disruptions to the economy will begin to ease. Jersey’s success in administering vaccines to the local population, with over ¾ of the adult population having now received their second dose, has allowed the Government to make advances in its reconnection plan. While infection rates increased rapidly in July, this has now fallen back. Stage 7 of the reconnection plan will mean that the majority of restrictions will be eased from 26 August.

The outlook for the global economy is of divergence between the recovery of advanced economies compared to ongoing disruption for emerging and developing economies. The progress of vaccination is expected to lead to a considerable normalisation of activity and more robust recoveries for almost all advanced economies, supported by accommodative monetary and fiscal policy. However, prospects have worsened for emerging market and developing economies, where a substantially lower proportion of the population have had access to vaccines. The potential for further problems with mutations of the virus resulting from the ongoing spread of infections presents a downside risk to the expected global recovery.

The UK, Jersey's main trading partner, has also made swift progress in vaccinating its population, allowing a significant lifting of restrictions. This has a resulted in an improved economic outlook, with the International Monetary Fund significantly upgrading its forecast for UK growth this year from 5.3% growth forecast in April to the latest forecast for 7% growth - the biggest upgrade of any major economy.

Jersey's latest economic data also point to a faster than expected recovery. The number of those actively seeking work (registered unemployment) has continued to fall from the peak it reached in May last year and the most recent reading showed only 120 more unemployed registered than before the start of the pandemic. This is a fall of 1,400 since the May 2020 peak

Data on claims under the Co-Funded Payroll Scheme can also be used as an indicator of the pace of recovery, as eligibility depends on the level of 'detriment' compared to pre-pandemic revenues. Fewer than 4,000 jobs were supported by the scheme in April 2021, compared to the peak of 16,000 jobs supported in April 2020. The most recent figures show around 2,000 jobs supported in May, though this is partly driven by a tightening of eligibility criteria.

A significant driver of the contraction in the economy in 2020 relates to reduced profitability in the banking sector. This is the result of falling policy interest rates. UK Bank Rate remains at a record low 0.1%, and market expectations for the medium term are for rate increases to be gradual. A significant proportion of Jersey deposits are held in other currencies, in particular US dollars, meaning that expectations for more rapid rate increases in the US would also be positive for the profitability of Jersey's banking sector. Data published by the Jersey Financial Services Commission indicate that profits for Jersey Incorporated Banks rebounded strongly in the first three months of this year, though this relates to reversing of some provisions and a reduction in operating expenses[1]. The reversal in provisions will not directly appear in GVA growth, and it is too early to judge whether the fall in operating expenses will be sustained through the remainder of the year.

Also promising in terms of the financial services sector is the continued growth of funds under administration which grew in value by over 8% (to £410bn) in the first three months of the year. This follows the 9% growth in value experienced last year and is also accompanied by annual growth close to 16% in March in funds under management. While much of this can be attributed to higher asset prices, it also indicates the continued strength of the sector. Globally, asset markets have performed strongly, with many indices at record highs.

Other available indicators generally support this story of recovery in the first half of this year:

- The Business Tendency Survey for June 2020 improved dramatically, especially for the financial services sector. Forward-looking indicators are at their strongest for five years and the headline 'business activity' indicator was stronger than it had been since before 2019 for both the finance and non-finance sectors. Responses from the hospitality remain broadly negative, but have shown a marked improvement and are the least negative since 2019.
- Advertised job vacancies have increased significantly and are now higher than for equivalent months in 2019.
- House prices continued upward in the first quarter of 2021, rising 2% since December. The number of transactions was in line with those for the first quarter of 2019 and 2020. In contrast average rents fell by 4% in comparison with the first quarter of 2020.
- RPI inflation rose to 3.5% in June, representing a significant acceleration from 0.8% in March 2021. This higher inflation rate is common to a number of industrialised economies, not least the UK.

[1] https://www.jerseyfsc.org/media/4688/key-trends-and-profitability-2021q1.pdf

- Air and sea departures have remained substantially depressed this year as the return to pre-pandemic travel patterns remains delayed. Departures in May were 87% lower than the corresponding monthly average from 2017-19. Bus patronage and town centre footfall remain below their pre-pandemic levels.

The significant level of government support offered in Jersey appears to have been broadly appropriate to economic conditions. Government has continued to support firms, especially hospitality and events, with an extension of the Co-Funded Payroll Scheme and schemes such as the Visitor Accommodation Support Scheme and Visitor Attractions and Events Scheme. Payments made to projects supported through the Fiscal Stimulus Fund will also support the economy.

The available evidence suggests that the downturn in the Jersey economy in 2020 was less sharp than previously expected, with the exception of the fall in banking profits (the official GVA estimate for 2020 will not be available until October this year). Further, the recovery in 2021 appears to be more rapid than expected. During the Panel's discussions with key stakeholders, there were a number of comments suggesting that this was leading to capacity shortages, both in the supply chain and in the labour market. Some stakeholders suggested that prices and wages may rise quickly in response. These issues have been exacerbated both by the ongoing effects of the pandemic and the end of the Brexit transition period, and it is uncertain how temporary they will prove to be.

Therefore, the Panel's view is that the output gap has started to close faster than had been expected at this stage of the recovery - as demand has recovered quickly but supply is at least temporarily constrained. However, this does not necessarily mean that the economy has reached its full capacity level – as demand continues to recover there is also likely to be an easing of supply constraints. Inflation and earnings growth may therefore be stronger in the short term, but employment growth during the later years of the forecast period will start to ease these pressures.

The Panel's updated forecast is:

- The recovery in financial services profits has been brought forward somewhat, with strong growth in 2022 and 2023, reflecting the updated market expectations of earlier (albeit modest) increases in Bank Rate and the Panel’s judgement on the impact interest rate rises will have on banking profits.

- A temporary period of inflation running significantly above trend, gradually falling back during the course of 2022.
- A more rapid rise in average earnings, in response to temporary labour shortages and high inflation. However, the forecast for high inflation would mean that earnings fall in real terms over the forecast, particularly in the non-finance sectors.
- A faster recovery in employment growth in 2023 and 2024.
- House prices rising more rapidly in the initial years of the forecast, reflecting the ongoing buoyancy of the property market and low interest rates.

On the basis of the Panel’s revised central forecast, the Government should plan on the basis of the output gap closing in 2024. Should supply constraints be eased more slowly, or become permanent, this would result in a more prolonged period of inflationary pressures and to the output gap closing more quickly than 2024.

Annex 2 illustrates an indicative quarterly profile of real GVA that is consistent with the updated forecast. This demonstrates that the Panel’s latest forecast still implies the economy will be smaller in the long run than it would have been had the economy followed the path of the pre-pandemic forecast though the structural reduction is smaller than we previously expected.

<u>Fiscal outcomes and advice</u>

Moving on to fiscal outcomes, the operating deficit for last year was £113m, a significantly better outcome than the £267m deficit estimated in the last Government Plan. This is in line with the signs that the economic downturn was less sharp than initially anticipated, and the recovery was more rapid. But it also indicates that fiscal and economic outcomes can sometimes diverge – for example because sectors of the economy that pay a large amount of tax have been less severely hit than sectors that pay relatively less tax. The full fiscal impact may also be delayed: the biggest driver of

Jersey's decline in GVA in 2020 (banking sector profits) will not be felt fiscally until 2021, as corporate income tax is paid on profits in the prior year.

However, in spite of the better-than-expected outcomes for 2020, the pandemic still presents significant fiscal challenges. In addition to the short-term costs of lost revenues and health and business support costs, there are also structural fiscal pressures due to the economy being smaller in the long run. These pressures will need to be tackled if the Island is to avoid having a structural deficit once the economy is recovered.

In line with the Panel's view that the output gap may be closed by 2024, this means that Government should aim for public finances to be broadly in balance by 2024.

A significant package of fiscal stimulus has been delivered over the last 16 months. The cut to employer Social Security contributions has now expired and the amount paid out under business support packages is winding down. The Panel would advise that beyond supporting the funding already allocated from the Fiscal Stimulus Fund, the Government of Jersey should not introduce any further new fiscal stimulus at the current time. It would however be prudent to ensure that flexibility remains to introduce further stimulus quickly should it be required as economic conditions evolve, in particular if fresh waves of the pandemic mean further severe lockdowns.

The States Assembly has been asked to approve borrowing of £800m to fund the Our Hospital project, with the borrowing being repaid through investment returns on the Strategic Reserve. The Panel previously advised (in 2016) that a similar strategy was sensible but, as with any potential alternative funding strategies, this approach is not without risk[2].

Repaying the borrowing through the investment returns on the Strategic Reserve will mean that (all else equal) the Strategic Reserve will grow more slowly than if the borrowing was repaid through, for example, increased taxes. The Panel has previously suggested that it would be prudent to aim to build the Strategic Reserve to 30%-60% of

[2] https://www.gov.je/SiteCollectionDocuments/Government%20and%20administration/L%20Letter%20from%20FPP%20to%20the%20Treasury%20Minister%20Ref%20Hospital%20Funding%20Strategy%2020161221%20VP.pdf

GVA. Therefore, a long-term plan is needed to grow the Strategic Reserve while also covering the borrowing costs from the investment returns.

However, in the short-to-medium term, any surpluses that occur during the forthcoming Government Plan period should be prioritised to rebuilding the Stabilisation Fund. While the Stabilisation Fund is being rebuilt, consideration should be given to maintaining a level of flexibility similar to that offered by the revolving credit facility.

The fiscal guideline to maintain and grow public sector net worth remains paramount and should inform any decisions around borrowing. In the case of the hospital, the borrowing will result in a reduction in net financial assets but an increase in physical assets – therefore the impact on public sector net worth may be relatively neutral. However, any windfalls or asset sales that occur should not be used for day-to-day spending. Using the proceeds of asset sales to fund such spending would have a negative effect on public sector net worth.

The Panel look forward to the publication of the proposed Government Plan in the autumn and will give further consideration to the implications for the public sector balance sheet in our subsequent Annual Report.

Yours sincerely

Kate Barker

Kate Barker (Chair)
Francis Breedon and Richard Davies

Annex 1: Updated economic assumptions

August 2021 forecast

% change unless otherwise specified	2020	2021	2022	2023	2024	Trend 2025+
Real GVA	-9.3	2.2	2.8	3.3	1.6	0.6
RPI	1.3	3.0	3.6	2.6	2.5	2.6
RPIY	1.2	3.0	3.5	2.5	2.4	2.5
Nominal GVA	-8.0	4.8	6.2	5.7	4.0	3.1
Gross operating surplus (including rental)	-17.7	6.1	10.2	9.2	5.2	3.2
Financial services profits	*-27.5*	*4.0*	*14.4*	*16.9*	*7.5*	*3.4*
Compensation of employees (CoE)	0.5	3.8	3.2	3.0	3.0	3.1
Financial services CoE	*1.5*	*3.5*	*3.5*	*3.5*	*2.8*	*3.4*
Non-finance CoE	*0.0*	*3.9*	*3.0*	*2.7*	*3.0*	*2.9*
Employment	-2.4	1.1	1.0	0.8	0.9	0.4
Average earnings	1.1	2.6	2.2	2.1	2.1	2.7
Interest rates (%)	0.2	0.1	0.2	0.5	0.5	0.6*
House prices	6.1	5.0	4.0	3.0	2.0	2.7
Housing transactions	-3.8	5.0	3.5	3.0	2.5	1.5

* Bank Rate forecast for 2025 only

April 2021 forecast

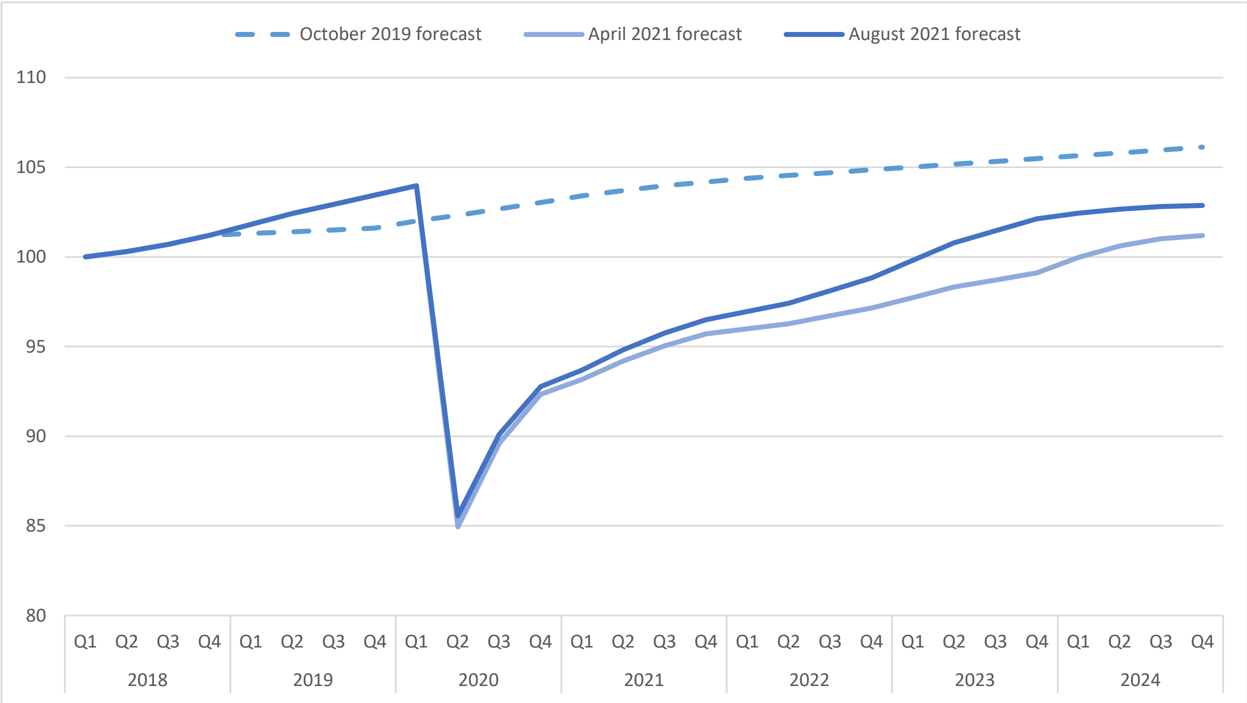
% change unless otherwise specified	2020	2021	2022	2023	2024	2025+
Real GVA	-9.7	2.0	2.1	2.0	2.3	0.6
RPI	1.3	2.1	2.6	2.5	2.5	2.6
RPIY	1.2	2.0	2.5	2.4	2.4	2.5
Nominal GVA	-8.3	4.2	4.3	4.4	4.7	3.1
Gross operating surplus (including rental)	-17.4	7.3	7.2	6.5	6.8	3.2
Financial services profits	*-27.5*	*4.0*	*8.0*	*10.0*	*12.0*	*3.4*
Compensation of employees (CoE)	-0.2	1.9	2.1	2.7	3.0	3.1
Financial services CoE	*2.0*	*1.0*	*2.7*	*2.9*	*3.1*	*3.4*
Non-finance CoE	*-1.5*	*2.4*	*1.8*	*2.5*	*2.9*	*2.9*
Employment	-1.3	1.1	0.9	0.6	0.4	0.4
Average earnings	1.1	0.8	1.2	2.0	2.5	2.7
Interest rates (%)	0.2	0.1	0.1	0.4	0.6	0.8*
House prices	4.5	2.0	2.2	2.4	2.6	2.7
Housing transactions	-3.8	5.0	3.5	3.0	2.5	1.5

* Bank Rate forecast for 2025 only

Change since April 2021 forecast

% change unless otherwise specified	2020	2021	2022	2023	2024	2025+
Real GVA	+0.4	+0.2	+0.7	+1.3	-0.7	0.0
RPI	0.0	+0.9	+1.0	+0.1	0.0	0.0
RPIY	0.0	+1.0	+1.0	+0.1	0.0	0.0
Nominal GVA	+0.3	+0.6	+1.9	+1.3	-0.7	0.0
Gross operating surplus (including rental)	-0.3	-1.2	+3.0	+2.7	-1.6	0.0
Financial services profits	*0.0*	*0.0*	*+6.4*	*+6.9*	*-4.5*	*0.0*
Compensation of employees (CoE)	+0.7	+1.9	+1.1	+0.3	0.0	0.0
Financial services CoE	*-0.5*	*+2.5*	*+0.8*	*+0.6*	*-0.3*	*0.0*
Non-finance CoE	*+1.5*	*+1.5*	*+1.2*	*+0.2*	*+0.1*	*0.0*
Employment	-1.1	0.0	+0.1	+0.2	+0.5	0.0
Average earnings	0.0	+1.8	+1.0	+0.1	-0.4	0.0
Interest rates (%)	0.0	0.0	+0.1	+0.1	-0.1	-0.2
House prices	+1.6	+3.0	+1.8	+0.6	-0.6	0.0
Housing transactions	0.0	0.0	0.0	0.0	0.0	0.0

Annex 2: Illustrative shape of FPP forecast



Index of real gross value added (GVA), Q1 2018=100