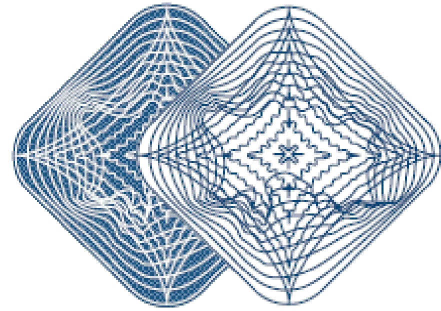


**Jersey’s Fiscal Policy Panel**

Deputy Susie Pinel
Minister for Treasury and Resources

7 April 2021

**Updated Economic Assumptions**

Dear Minister,

Please find our updated economic assumptions at Annex 1. These assumptions are provided for use in forecasting government revenues and expenditure to prepare for the Government Plan 2022-25.

This set of assumptions is provided against a highly uncertain backdrop. Jersey has set out a clear roadmap for the lifting of Covid-19 restrictions. This ‘reconnection plan’ is made possible by the progress in administering vaccines – with over half of Jersey’s population now having already received at least one dose - and this should lead to a continued improvement in economic conditions. However, it is likely that the pandemic will have caused long-term ‘scarring’ effects on the economy. This means that there is a risk Jersey will not recover to the level of economic output expected before the pandemic in the years covered by the Government Plan.

Prospects for the global economy are similarly uncertain, with some signs of strength alongside a number of remaining risks. Trade in goods and manufacturing production have both rebounded more quickly than expected, and while restrictions remain in many

countries, these are having less impact on economic activity than the restrictions that were introduced in the first half of 2020. The significant fiscal stimulus in the US will provide a boost to global growth overall. However, the speed and effectiveness of the vaccine rollout is key to the recovery across all countries.

The UK, Jersey's main trading partner, has also made significant progress in its vaccination programme. However, the prolonged nature of lockdowns and restrictions brought about by a spike of Covid-19 cases means that the economy is expected to shrink in quarter 1 of 2021, before recovering in the remainder of the year. The March forecast from the Office of Budget Responsibility (OBR) is for the UK economy to only return to its pre-crisis level of economic output by the middle of 2022.

Following a spike in infections towards the end of 2020, the prevalence of Covid-19 has fallen considerably: Jersey has recorded 2.8 cases per 100,000 population and zero deaths per million in the fourteen days to 1 April. For context, the UK recorded 110 cases per 100,000 and 16 per deaths per million over the same period, while France recorded 704 cases and 62 deaths[1]. Jersey has administered 55.4 vaccine doses per 100 population; compared to 55.2 in the UK and 18.1 in France[2].

Recent data for Jersey suggest that the restrictions put in place towards the end of 2020 did not cause an increase in those actively seeking work (registered unemployment) like that seen following the first round of restrictions earlier in the year. Seasonally-adjusted unemployment has continued to fall, but remains around 550 higher than a year ago.

Use of the Co-Funded Payroll Scheme did however increase, with around 7,000 jobs supported through the scheme in January – an increase from less than 5,000 in November 2020. These claims however remained significantly below the peak of 16,000 for April 2020. As the scheme is restricted to firms suffering a significant reduction in turnover, this suggests that the impact of the second round of restrictions has been much less severe. Around half of the support in recent months has been paid to firms in the hospitality sector, which suggests that the economic impact of the second round of

[1] https://www.ecdc.europa.eu/en/publications-data/data-national-14-day-notification-rate-covid-19

[2] https://ig.ft.com/coronavirus-vaccine-tracker

restrictions was much more concentrated than the restrictions introduced in March 2020.

Data published by the Jersey Financial Services Commission (JFSC) show that profits for Jersey Incorporated Banks fell sharply in 2020[3]. A significant driver of the Panel's forecast for 2020 relates to profitability in the banking sector, which is heavily influenced by the level of UK Bank of England base rate, and other policy rates. As Jersey is primarily a deposit-taking centre, lower interest rates mean a squeeze on net interest margins and a reduction in profits. At the end of March 2020, the Bank of England cut its policy rate to a record low of 0.1%, and there were cuts elsewhere including in the US. The data published by the JFSC covers only part of the banking sector in Jersey (a large number of operations are branches of banks incorporated in other jurisdictions) but provides useful evidence of the scale of the impact from the fall in interest rates.

The outlook for interest rates has however markedly changed since our last set of economic assumptions in October 2020, with markets now expecting that rates could return to 2019 levels by 2025. This means there is potential for banking profits to recover more quickly, and a further reduction of the UK base rate into negative territory now appears much less likely.

There has been a strong performance for funds under administration in Jersey, which grew by 9% in 2020. Overall, the finance sector in Jersey has proven resilient and has been able to adapt readily to the challenges of the pandemic. However, significant risks and challenges still remain for the sector in the medium and longer term.

Statistics Jersey has published new, experimental quarterly data on the non-finance private sector. Data for the first half of last year show that profitability also fell in this part of the economy – with construction, hospitality and other business activities all suffering losses in quarter 2 and profits for private non-finance as a whole falling by 87% compared to the same quarter in 2019. However, total wages and salaries, supported by the payroll scheme, fell by only 7% suggesting that profits took the biggest hit from the 30% reduction in revenues (though the data imply that firms were able to reduce

[3] https://www.jerseyfsc.org/media/4249/key-trends-and-profitability-2020q4-v2.pdf

non-staff costs by around a quarter). The Panel welcomes the publication of these new experimental data and the next release will be key to showing how quickly these non-finance sectors were able to recover in the second half of the year.

Indicators available to date suggest a gradual recovery in the second half of the year:

- The Business Tendency Survey for December 2020 was much stronger than June, though in aggregate terms it has fallen back a little since September reflecting the reimposition of some restrictions. The financial services sector was positive across most of the indicators and strongly positive for the future; whilst the hospitality sector was strongly negative including for the future.
- Advertised job vacancies have increased very significantly from their lows though still remain well below pre-crisis levels.
- House prices grew by 4.5% in 2020. The number of transactions fell, but this was partly due to the difficulty in marketing and completing sales in residential property during the lockdown. Average rents increased by 3.5%.
- RPI inflation remained at 0.9% in December 2020. On average, prices were 1.3% higher in 2020 than in 2019, in line with the FPP forecast. RPIY inflation averaged 1.2%.
- Air and sea departures during the peak summer months were significantly below previous years before falling sharply in the final months of the year, with total departures 79% lower in 2020 compared with the average over 2017-2019. Latest data shows that road traffic has returned close to pre-pandemic levels, but bus passengers and town centre footfall remain low.

Jersey’s Government has continued to support the economy appropriately, with the extension of the Co-Funded Payroll Scheme; further deferrals of GST and Social Security Contributions and new schemes such as the Visitor Accommodation Support Scheme and Visitor Attractions and Events Scheme. In addition, fiscal stimulus has been provided through the Spend Local card, one-off payments to low-income households and a temporary reduction to employee Social Security contributions.

Tranche 1 of funding from the £50m Fiscal Stimulus Fund for 2021 will be awarded shortly and applications for tranche 2 are currently under consideration.

The Panel's updated forecast is:

- A sharper-than-expected fall in financial services profits in 2020, reflecting the latest data on banking profits. However, the outlook for interest rates has improved and this is expected to result in stronger growth in financial services profits in the later years of the forecast.
- The fall in non-finance GVA in 2020 is now more heavily weighted to a reduction in profits, with compensation of employees falling less sharply. However, in overall 'gross operating surplus' (GOS) the sharper fall in non-finance profits is offset by stronger forecast growth in the rental income of private households – which is included in GOS.
- The balance between profits and earnings in the private non-finance sectors is forecast to return to pre-pandemic shares over the course of the forecast.
- Employment falls by around 1% in 2020 before recovering back to 2019 levels by 2022
- Inflation increasing in 2021 but not returning to its long-term average until 2022, consistent with forecasts of inflation in the UK.
- A slowdown in house price growth, largely keeping up with overall inflation.

The overall impact of the revisions to the forecast are a further downgrade to the estimate of GVA in 2020, to around a 10% fall – the largest decline in GVA in the period over which a consistent set of data are available (since 1998). The recovery is forecast to be more gradual, determined in part by the increase in financial services profits not strengthening until towards the end of the forecast.

While more data are now available for 2020 there still remains considerable uncertainty around the size of the downturn, which will not become clear until much later this year. The recovery in 2021 and onward is dependent on both the speed and effectiveness of the vaccine rollout and on the future path of interest rates and their impact on banking

profitability. However, at this point the Panel continues to advise that Jersey's economy is likely to remain smaller in the long run than was forecast ahead of the pandemic. This is demonstrated in Annex 2, which shows an indicative quarterly profile of real GVA that is consistent with the updated forecast. While the size of the structural impact is highly uncertain, the Panel's latest forecast of the longer-term trend path of GVA is broadly unchanged from the forecast from August 2020.

It is widely accepted that there is always considerable uncertainty around economic prospects. In common with many other forecasters, the Panel has also produced a 'high' and 'low' set of economic assumptions, that can be used to help produce a range for fiscal forecasts. Annex 3 of this letter sets out two alternative scenarios for GVA, employment and earnings growth.

**Fiscal outcomes and advice**

Moving on to fiscal outcomes, the forthcoming publication of the States of Jersey Annual Report and Accounts will set out the overall fiscal performance in 2020. Even if the deficit in 2020 was smaller or larger than forecast, acute fiscal challenges remain and the reduction in the size of the economy relative to the pre-pandemic forecast with previous spending plans means that there is likely to be a structural deficit in the medium term. The slower recovery of the economy in the Panel's updated forecast means that it would be appropriate to plan to close this deficit more slowly so that the pace of fiscal contraction does not undermine the recovery. Therefore, the Panel advises that it would be prudent to aim to balance the budget by 2025, the final year of the forthcoming Government Plan.

In light of the uncertainty about how Jersey and indeed the global economy will move to a sustained recovery, the need for Budget flexibility remains. If the economic recovery falters, Government should allow the automatic stabilisers to work and consider the need for further fiscal stimulus. Conversely, the flexibility needs to be there for fiscal consolidation to be implemented more quickly if the economy recovers faster. At this stage, it remains appropriate that significant revenue-raising measures should not be implemented soon but the Government should plan and develop revenue measures that

can be used alongside efficiencies and reductions in spending to close the structural deficit.

The Panel recommended in the 2020 Annual Report that the size of the structural fiscal deficit should be clearly set out in the forthcoming Government Plan. The exact size of the structural deficit is very uncertain, but the Government Plan should provide an estimate based on the current economic forecast. A plan and a credible commitment to close the structural deficit is important, but at this stage it is reasonable that it may not be possible to produce a detailed plan of all measures that will be taken over the next four years.

While the revolving credit facility was not drawn down in 2020, it is planned that the Fiscal Stimulus Fund will be financed by borrowing. Borrowing should remain the preferred route to financing deficits, with financial reserves maintained to provide flexibility to respond to any future shocks in which borrowing could be more costly – consistent with our advice in 2020. The Panel should be consulted as a medium-term debt strategy is developed.

The Government Plan 2021-2024 included a planned significant increase in capital investment, including investment by subsidiary companies such as Andium, Ports of Jersey and States of Jersey Development Company. Large projects such as Our Hospital and Fort Regent are additional to this and will put further pressure on resources in the construction sector. It would be challenging, and probably inadvisable, to attempt to coordinate or change the timing of large-scale capital projects to ensure they provide fiscal stimulus at an appropriate time. But there is a risk that a large ramp up in capital spend occurs after the output gap has been closed and therefore a risk that these projects result in the economy overheating. Further, construction sector capacity may be a constraint even before the economic recovery is complete. Therefore, it is important to continue to plan how this significant capital programme can be delivered without creating constraints in the sector or the economy more widely.

In conclusion, the Panel has downgraded its forecast for 2020 and now expects the economy to recover more gradually. This means that it is appropriate to aim to close the deficit more slowly – with a plan to balance the budget only by 2025. Deficits over the

course of the forthcoming Government Plan should be funded through borrowing, rather than by drawing down on reserves.

The Panel will provide a further set of economic assumptions later this year, in order to inform the fiscal forecasts that underpin the Government Plan 2022-2025. Should economic conditions change significantly, the Panel is ready to update its forecast and fiscal advice as required.

Yours sincerely

Kate Barker (Chair)
Francis Breedon and Richard Davies

## Annex 1: Updated economic assumptions

**March 2021 forecast**

| *% change unless otherwise specified* | 2020 | 2021 | 2022 | 2023 | 2024 | Trend 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

**Previous (October 2020) forecast**

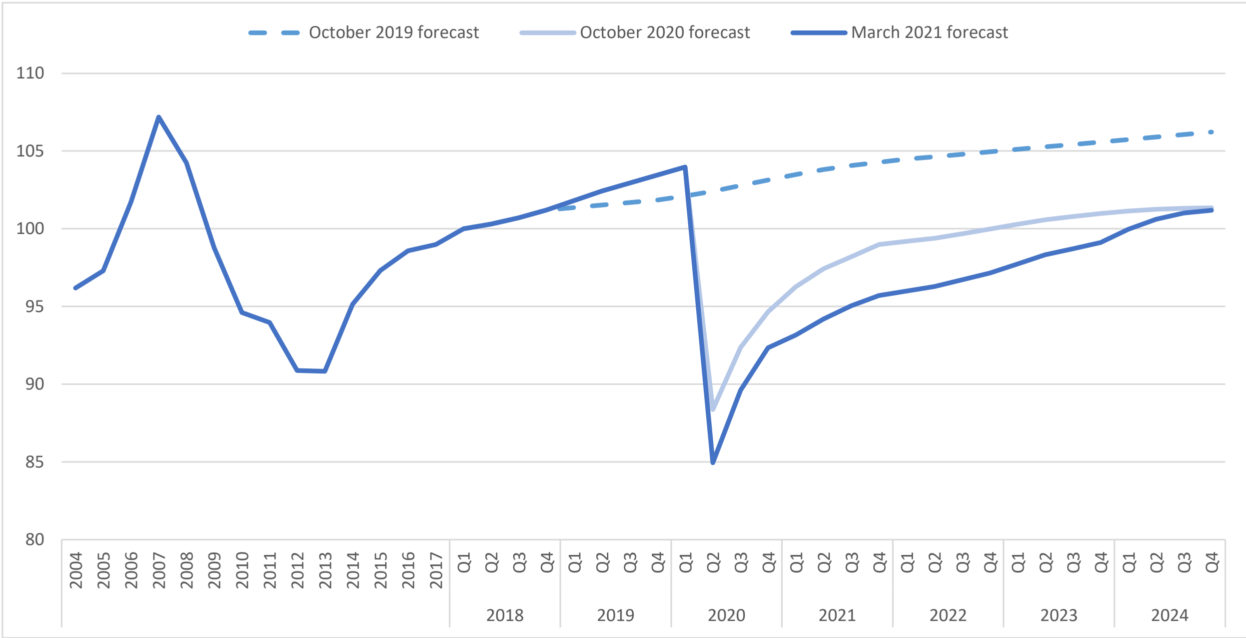
| *% change unless otherwise specified* | 2020 | 2021 | 2022 | 2023 | 2024+ |
|---|---|---|---|---|---|
| Real GVA | -7.6 | 3.0 | 1.9 | 1.1 | 0.6 |
| RPI | 1.3 | 1.5 | 2.4 | 2.5 | 2.6 |
| RPIY | 1.5 | 1.4 | 2.3 | 2.4 | 2.5 |
| Nominal GVA | -6.4 | 3.9 | 3.2 | 2.9 | 3.1 |
| GOS (including rental) | -13.1 | 7.1 | 3.3 | 2.6 | 3.2 |
| *Financial services profits* | *-18.6* | *8.0* | *6.0* | *4.0* | *3.4* |
| Compensation of employees | -0.6 | 1.5 | 3.2 | 3.1 | 3.1 |
| *Financial services CoE* | 3.0 | 0.0 | 2.7 | 2.9 | 3.1 |
| *Non-finance CoE* | -2.6 | 2.4 | 3.4 | 3.2 | 3.1 |
| Employment | -1.6 | 1.2 | 0.9 | 0.6 | 0.4 |
| Average earnings | 1.1 | 1.1 | 2.3 | 2.5 | 2.7 |
| Interest rates (%) | 0.2 | -0.1 | -0.1 | -0.1 | 0.0* |
| House prices | 0.0 | -2.0 | 2.7 | 2.7 | 2.7 |
| Housing transactions | -20.0 | 10.0 | 1.5 | 1.5 | 1.5 |

* Bank Rate forecast for 2024 only

**Changes since last forecast**

| *percentage point change* | 2020 | 2021 | 2022 | 2023 | 2024 |
|---|---|---|---|---|---|
| Real GVA | -2.1 | -1.0 | +0.2 | +0.9 | +1.7 |
| RPI | 0 | +0.6 | +0.2 | 0 | -0.1 |
| RPIY | -0.3 | +0.6 | +0.2 | 0 | -0.1 |
| Nominal GVA | -1.9 | +0.3 | +1.1 | +1.5 | +1.6 |
| GOS (including rental) | -4.3 | +0.2 | +3.9 | +3.9 | +3.6 |
| *Financial services profits* | -8.9 | -4.0 | +2.0 | +6.0 | +8.6 |
| Compensation of employees | +0.4 | +0.4 | -1.1 | -0.4 | -0.1 |
| *Financial services CoE* | -1.0 | +1.0 | 0 | 0 | 0 |
| *Non-finance CoE* | +1.1 | 0 | -1.6 | -0.7 | -0.2 |
| Employment | +0.3 | -0.1 | 0 | 0 | 0 |
| Average earnings | 0 | -0.3 | -1.1 | -0.5 | -0.2 |
| Interest rates (%) | 0 | +0.2 | +0.2 | +0.5 | +0.6 |
| House prices | +4.5 | +4.0 | -0.5 | -0.3 | -0.1 |
| Housing transactions | +16.2 | -5.0 | +2.0 | +1.5 | +1.0 |

## Annex 2: Illustrative shape of FPP forecast




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

## Annex 3: High and low scenarios

This forecast is produced at a time of unusual short-term uncertainty regarding the global and local economies. The unprecedented degree of disruption caused by the Covid-19 pandemic and the necessary public health measures to control it means that, at this stage, despite some data being available for the year, there remains a range of plausible outcomes for important economic variables in 2020.

Further, there is uncertainty about the future path of the pandemic, both globally and locally, and around how this will affect economic activity. Globally, infection rates fell in the early part of 2021 but in recent weeks have started to climb as a 'third wave' has hit many countries. Vaccination offers a route out of the worst effects of the pandemic but there remains a risk that globally the economic impact persists for much of 2021. Jersey has seen a recent return to very low rates of infection and the pace of vaccinations allows progress through the reconnection strategy that will see restrictions eased in the coming months; but given the path of worldwide infections there is no guarantee of a swift return to normality.

Therefore, the Panel's high and low scenarios have focussed on two elements:

1. The uncertainty around the economic impact of the pandemic in 2020;
2. The uncertainty around the future path of the pandemic through 2021 and the impact this will have on economic activity.

The high and low scenarios set out below cover both 2020 and 2021 but do not extend further. This certainly does not mean that there is no uncertainty for 2022 and beyond. The two scenarios can be described as:

<u>The high scenario</u> is one in which the economic impacts of the disruption in 2020 are significant, but less so than in the central scenario. There is a small fall in employment, and a smaller hit to profitability in the finance sector and in non-finance sectors. For 2021, it is assumed that restrictions are eased in line with the reconnection strategy and inbound visitor travel recovers strongly – resulting in a stronger recovery particularly in the hospitality sector. Financial services profits are expected to grow more markedly, as global economic conditions improve.

<u>The low scenario</u> is one in which the pandemic had a greater negative impact on economic growth in 2020 than the Panel's central forecast. The economic recovery in the second half of the year is weaker than in the central scenario, resulting in annual average employment falling more sharply and a larger hit to profits in non-finance sectors. Finance sector profits fall more sharply, as the impact of falling interest rates on banking profits is more acute and the disruption results in challenges to profitability in the remainder of the finance sector. For 2021, the path of the pandemic is more severe, with a weaker global recovery and a greater degree of restrictions including restrictions on inbound travel. The result is a weaker recovery, particularly in the financial services and hospitality sectors.

The tables below set out the impact of these scenarios on the components of GVA: the compensation of employees and the gross operating surplus of firms, along with earnings and employment that largely determine the compensation of employees. 2020 inflation, house prices and interest rates are all known and while there is uncertainty around the appropriate assumptions for these variables in 2021, this is more difficult to judge. For example, our analysis demonstrates that inflation in Jersey excluding housing is, on average, largely driven by inflation in the UK, and the Bank of England sets interest rates and monetary policy to meet a target for UK inflation. The housing market is also strongly influenced by monetary policy and its impact on mortgage rates. Our central forecast is consistent with forecast developments in the UK for inflation and interest rates but in the scenarios presented here we have focused on the uncertainty for key developments within the Jersey economy in the short term, rather than develop a complete forecast for the medium term that would encompass a set of wider judgements that are less relevant.

**March 2021 forecast (high)**

| *% change* | 2020 | 2021 |
|---|---|---|
| Real GVA | -6.4 | 4.7 |
| Nominal GVA | -4.9 | 6.8 |
| Gross operating surplus (including rental) | -11.5 | 9.7 |
| *Financial services profits* | -22.5 | 8.0 |
| Compensation of employees (CoE) | 0.9 | 4.7 |
| *Financial services CoE* | 2.2 | 2.0 |
| *Non-finance CoE* | 0.3 | 6.2 |
| Employment | -0.8 | 2.8 |
| Average earnings | 1.1 | 1.8 |

**March 2021 forecast (low)**

| *% change* | 2020 | 2021 |
|---|---|---|
| Real GVA | -12.3 | -0.6 |
| Nominal GVA | -10.9 | 1.5 |
| Gross operating surplus (including rental) | -22.4 | 5.1 |
| *Financial services profits* | -32.5 | 0.0 |
| Compensation of employees (CoE) | -1.3 | -1.0 |
| *Financial services CoE* | 1.8 | -2.0 |
| *Non-finance CoE* | -3.3 | -0.4 |
| Employment | -1.8 | -0.3 |
| Average earnings | 1.1 | -0.7 |