Jersey's Fiscal Policy Panel

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

5 August 2020

Updated Economic Assumptions

Dear Minister,

Thank you for your letter dated 31 July. The Panel is encouraged that Jersey has been successful in containing the spread of Covid-19 in the Island and has been quick to put in place measures to mitigate the economic impact. However, there remains a high level of uncertainty around the impact of the pandemic on both the global and local economy.

In June, the International Monetary Fund (IMF) forecast the global economy to shrink by around 5 per cent this year – only the second contraction since the 1940s and far outweighing the relatively small fall in world GDP in 2009. This compares with the IMF's forecast from April, which anticipated a contraction of 3 per cent this year.

The IMF forecast assumes that persistent social distancing, economic scarring and reduced productivity (due to the cost of safety and hygiene measures) mean that a quick recovery has become much less likely even in countries with declining infection rates. Further, countries who struggle to control infection rates will be required to implement longer lockdowns with increased disruption to economic activity. The latest

IMF forecast therefore assumes a more gradual and partial recovery, now more similar to the profile of our March forecast for the Jersey economy.

Financial markets have been highly volatile since March. For example, both the UK (FTSE-100) and US (S&P 500) benchmark indices initially lost around 1/3 of their value. UK equities have since recovered around half of this, while the US benchmark has recovered almost all the losses.

Global trade has been severely impacted by the coronavirus pandemic, with supply chains disrupted and significant reductions in demand. The World Trade Organisation (WTO) estimates that trade fell by 18.5 per cent in the second quarter compared to a year earlier. The WTO suggests that a quick recovery in world trade is not guaranteed, and will depend on fiscal, monetary and trade policies continuing to be supportive.

While the outbreak of coronavirus in Jersey has been much more limited than in many other jurisdictions, preventing a severe outbreak required unprecedented restrictions on economic activity. The data available to date suggest that this has resulted in a steep contraction in Jersey's economy in the second quarter, consistent with that expected at the time of the FPP's March forecast.

- Registered unemployment peaked in May at 2,380[1] – an increase of 1,500 since the beginning of 2020. The latest data from 26 July show a reduction of around 600 from this peak, but unemployment remains more than double the level of a year earlier.
- The number of Class 1 Social Security contributors (a proxy for jobs) saw a modest annual fall in January and February but a more significant fall in March of 1.5 per cent. The same data suggest earnings have been holding up in March. However, a more significant decline in both employment and earnings is likely to be seen in quarter 2.

[1] To allow comparison with previous years, this excludes a further 330 registered as actively seeking work and claiming the new CRESS payment. This number has also reduced, falling by more than 60 per cent since the peak in May.

- Analysis from Digital Jersey suggest that online job postings for vacancies, which are a good measure of labour demand, fell from 1,200 in February to 150 in April and have recovered very slowly since.
- The Business Tendency Survey for June 2020 showed business sentiment at its lowest level since the survey began in 2009. The results suggested that while all sectors were experiencing severe challenges, this was most pronounced in the hospitality, construction and retail sectors.
- Inflation has fallen to a five-year low, with the RPI increasing by only 0.5 per cent in the year to June 2020. This weaker inflation is largely driven by the factors identified in our previous letter – the falls in oil prices and mortgage interest rates. However, there are some one-off factors relating to temporary government policy, including the suspension of parking charges and the reduction in GP fees.
- Activity in the housing market was severely restricted, with administrative data suggesting the number of transactions in quarter 2 were less than half the same period in 2019 – though this is partly the result of a very strong quarter last year when a large number of new apartments were completed. However, activity has come back strongly since restrictions have been eased.
- High-frequency data suggest that movement around the Island reduced markedly during the period of restrictions and has yet to return to pre-pandemic levels.
    - Weekly footfall in King Street has increased significantly since April, but in July remained more than 40 per cent down on the same period last year.
    - Road traffic fell by more than half but is back close to last year's levels.
    - Bus passenger numbers fell as low as 5,000 per week in April – compared to around 90,000 in the same period last year. Passenger numbers have increased since to around 40,000 in July but this is around 70 per cent lower than the same period last year.

The Government of Jersey has been proactive in addressing both the health and economic challenges. Jersey has carried out over 40,000 PCR tests, a much greater rate of testing than most jurisdictions, including testing the majority of arriving passengers at the airport and harbour. This will help to provide comfort and confidence to local consumers and to prospective visitors.

In common with other developed economies, Jersey has also put in place an unprecedented package of support and fiscal stimulus:

- The Co-Funded Payroll Scheme provided £2m of support to firms under Phase 1 and £55m to 26 July under Phase 2. There has been a gradual reduction in the number of claims each month, with the number of jobs supported reducing from 16,000 in April to 11,000 in June. The Scheme has recently been extended to provide tapered support out to March 2021.
- The Business Disruption Loan Guarantee Scheme has provided lending of around £3m to businesses so far.
- Businesses have been given the option to defer payments of GST and Social Security contributions relating to the first half of the year.
- The Covid-related emergency support scheme supported 330 individuals at its peak, providing payments to residents who had recently lost employment but were ineligible to claim income support.
- Government has announced a £100m stimulus programme, providing direct payments to low income households, vouchers to all residents to support local spending, a reduction in employee Social Security contributions, and a fiscal stimulus pot.
- Extended time-to-pay GST and Social Security deferrals and converting *prior-year-basis* (PYB) taxpayers onto *current-year-basis* (CYB) will keep additional money in the economy over the next twelve months.

These schemes have provided additional liquidity to both businesses and households than would have otherwise been the case. The Panel has therefore updated its economic forecast on the basis that these schemes are successful in supporting the economy with smaller falls in income and employment than would have been the case without support.

The Panel’s central forecast is:

- A significant fall in employment, particularly in those sectors most affected by the restrictions in place. Overall, we expect employment to fall by around 1.6 per cent this year, on an annual average basis.
- Largely flat average earnings in nominal terms this year. This reflects a judgement that while earnings in finance and the public sector are unlikely to be significantly reduced, falls in hours and earnings are considerably more likely in those sectors most affected by the restrictions and falls in economic activity. While the official statistics for earnings are based on growth from June-to-June, this is likely to be especially volatile this year. Restraint in financial services sector bonuses will act as a drag on the economy next year.
- Our forecast for interest rates follows market expectations. This suggests no recovery in Bank Rate set by the Bank of England over the forecast horizon. While the forecast suggests the rate will go slightly negative, this is not necessarily the Panel’s expectation - our convention is to use the average expectation implied by the market price of UK government debt securities.
- As a result of the expected prolonged period of very low benchmark interest rates, in the euro area and US as well as the UK, profits in the banking sector are likely to see significant reductions this year. The latest cut in Bank Rate occurred just as the Panel was finalising the March forecast, and the outlook for interest rates has fallen further since then.
- Profits in the non-finance sectors are also forecast to see considerable falls this year with firms unable to recover revenues lost during the period of restrictions, but without being able to reduce their costs to the same extent. Profitability is expected to recover slowly as demand remains weak.
- While RPI inflation fell to 0.5 per cent in June, this was partly due to one-off temporary factors. We expect inflation to increase from this level but remain below its trend rate for the remainder of this year and into next year.

- The housing market was largely put on pause for several weeks but, as the period of restriction has come to an end, transaction volumes have rebounded strongly. However, the Panel's central forecast is that over the course of the year there will still be considerably fewer transactions than in 2019. While low interest rates will support the market, this must be balanced against the economic situation with weaker employment and earnings, and therefore we forecast prices to remain broadly flat over the next two years.

Overall, compared with March, the Panel's forecast is for a slightly steeper fall in real GVA this year and a slower recovery. This is driven by a considerable reduction in banking profits, which make up a significant share of output (GVA) in Jersey's economy. However, as this has already been factored into the latest revenue forecasts prepared by Government, this may not result in a significant further impairment to Jersey's fiscal projections.

Annex 2 to this letter shows an illustrative quarterly profile of real GVA that aligns with the Panel's updated annual forecast. This suggests a very steep fall in activity in quarter 2, with only a partial recovery in the remainder of the year and an economy that remains smaller throughout the forecast period.

The Panel's March forecast implied that Jersey's economy would be around 4.5 per cent smaller by 2024, in real terms, compared with the October 2019 forecast. This highlights the likelihood for significant structural damage to the potential output of the economy. Our revised forecast reduces the forecast level of real GVA in 2024 further, such that it would be 6 per cent smaller than our pre-pandemic forecast.

While it is too early to have much certainty around the structural impact of the pandemic on Jersey's economy, the Panel advise that it would be prudent to plan on the basis of a long-term reduction in the size of Jersey's economy relative to its projected potential prior to the global pandemic. At this stage the Panel has not revised its judgement for the trend rate of growth of the economy, but our central forecast is that while we have not changed the trend *rate* of growth, the *level* of trend GVA is now likely to be considerably lower. The Panel will review its forecast for the trend rate of growth when the impact of Covid-19 is better understood.

Both the level of trend GVA and future trend growth are sensitive to a number of factors – in particular the structure of Jersey's economy following the recovery, the short- and medium-term prospects for migration, and the outlook for benchmark interest rates. A key factor driving the weaker outlook up to 2024 is persistently low interest rates. While the Panel considers that the economy may be back to its potential by 2024, the measured size of the economy (and tax receipts) may remain smaller due to the importance of interest rates to banking profits.

As in March, considerable uncertainty remains as to the outlook for the global economy, and locally. While Jersey has outperformed many other jurisdictions in relation to health outcomes, the economic impacts will remain uncertain for some time.

It is clear, however, that there has been a major deterioration in the outlook for Jersey's public finances. There have been cost pressures in relation to health expenditure, the testing and track-and-trace programmes, the economic support schemes and the fiscal stimulus package. Fiscal pressures are compounded by the anticipated falls in government revenue, with the Income Forecasting Group (IFG) reducing its forecast by over £100m this year and next – with significantly reduced revenue persisting throughout the forecast period to 2024.

This will result in a large deficit in 2020 and if the indicative spending plans in the current Government Plan are maintained then, on the basis of the latest revenue forecast, deficits will persist throughout the Government Plan period. The Panel does not recommend that large cuts in expenditure or new revenue streams are introduced quickly to close this structural deficit. Rather, the Government of Jersey should continue to run deficits in the short term to support the economy while it remains below trend. In the medium term however, the deficit should be closed as the economy recovers such that the budget is balanced when the economy comes back to its trend level. As stated above, it is very difficult to predict how quickly the economy will recover, or to what level, but a prudent approach now would be to aim to close the deficit by the end of the 2021-24 period, with flexibility to revise the pace of fiscal consolidation in either direction as the economy recovers.

Jersey has put in place a Revolving Credit Facility (RCF) to provide up to £500m of borrowing. If fully drawn down this would represent a substantial increase in Jersey's external borrowing, which stood at £260m at the end of 2019. While Jersey had substantial reserves in place (with £3.7bn of cumulative investment holdings at the end of 2019) the performance of financial markets in 2020 suggests the potential for investment losses on some assets to reduce the value of these reserves – at least in the short term.

One of the fiscal guidelines set out in the current Government Plan is that government should '*borrow only to finance investment (or refinance liabilities), except under times of economic duress, and monitor the impact on net financial assets*.' This guideline is an important one for long-term fiscal sustainability and should continue to be followed. However, at the current juncture:

- It would be appropriate for Jersey to borrow, rather than to draw significantly on reserves, to attempt to smooth the economic cycle. This means that in the absence of a substantial balance on the Stabilisation Fund, Government should consider financing both the automatic stabilisers and discretionary fiscal policy such as the Covid-19 stimulus through borrowing. This is preferable to excessive fiscal consolidation, which would intensify the structural impact of the very sharp short-term fall in economic activity.
- Borrowing remains a sensible option to fund investment. If this results in a physical asset that either provides a financial return or provides services that Islanders need over time, then it need not reduce the overall net asset position (it reduces net financial assets but increases physical assets). In Jersey examples include a new hospital, infrastructure and housing.
- Some of the reduction in revenues is due to the Government of Jersey deferring the collection of some taxes and contributions that would have otherwise been due this year. This includes the deferral of businesses' GST and Social Security contributions due for the first half of the year, and the personal tax liabilities of those previously on the '*prior-year-basis'* (PYB) approach to calculating tax liabilities. It could be appropriate for Government

to borrow to fund these cashflow measures as they will result in additional revenues in the future when these liabilities are repaid.

While it would also be possible to consider the drawdown of reserves to fund these objectives, this may present a risk if some financial assets are relatively illiquid. Further, the maintenance of a significant financial asset position helps to make Jersey more resilient to future shocks and provides more flexibility between financing options in the future.

In summary, the Panel has further downgraded its forecast for Jersey's economy since March, as a result of the impact of a prolonged period of low interest rates on banking profits. Spending pressures and reduced revenues mean that Jersey will have a significant budget deficit this year, and current spending plans mean a deficit would persist in future years. The Government of Jersey should avoid trying to close this deficit too quickly but should seek to address any structural imbalance over the period of the forthcoming Government Plan. The structural impact of Covid-19 on the economy, and therefore on public finances, is highly uncertain but it would be prudent for the government to plan to eliminate the deficit by 2024 while maintaining the flexibility to respond to changes in the economic outlook.

The Panel looks forward to reviewing the draft Government Plan for 2021-2024 when it is lodged later this year. Should economic conditions change significantly before then, the Panel stands ready to update its economic forecast and its fiscal advice.

Yours sincerely

Kate Barker

Kate Barker (Chair)
Francis Breedon and Richard Davies

Annex 1: Updated economic assumptions

August 2020 forecast

% change unless otherwise specified	2017	2018	2019	2020	2021	2022	2023	Trend 2024+
Real GVA	0.8	1.4	0.6	-7.5	3.0	1.9	1.1	0.6
RPI	3.1	3.9	2.9	1.3	1.5	2.4	2.5	2.6
RPIY	3.2	3.6	2.6	1.5	1.4	2.3	2.4	2.5
Nominal GVA	4.1	5.9	3.9	-6.3	3.9	3.2	2.9	3.1
Gross operating surplus (including rental)	-0.3	7.5	4.3	-12.9	7.1	3.2	2.6	3.2
Financial services profits	*-6.4*	*9.6*	*2.0*	*-18.6*	*8.0*	*6.0*	*4.0*	*3.4*
Compensation of employees (CoE)	8.1	4.6	3.6	-0.6	1.5	3.2	3.1	3.1
Financial services CoE	*10.0*	*2.5*	*3.3*	*3.0*	*0.0*	*2.7*	*2.9*	*3.1*
Non-finance CoE	*7.0*	*5.8*	*3.7*	*-2.6*	*2.4*	*3.4*	*3.2*	*3.1*
Employment	2.3	1.4	1.2	-1.6	1.2	0.9	0.6	0.4
Average earnings	2.6	3.5	2.6	0.3	1.1	2.3	2.5	2.7
Interest rates (%)	0.3	0.6	0.8	0.2	-0.1	-0.1	-0.1	0.0*
House prices	2.9	7.1	7.0	0.0	-2.0	2.7	2.7	2.7
Housing transactions	7.8	5.3	-1.8	-20.0	10.0	1.5	1.5	1.5

* Bank Rate forecast for 2024 only

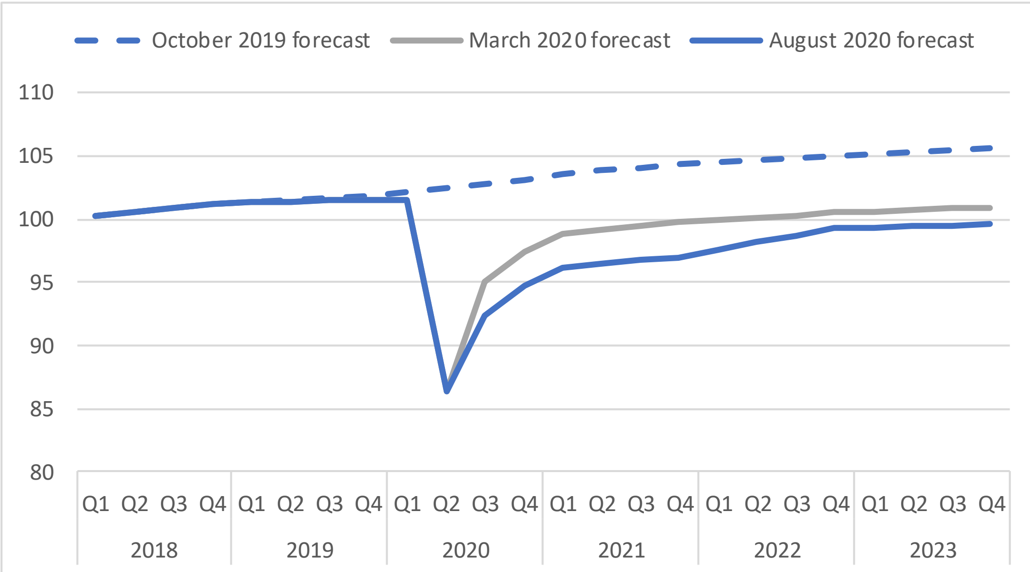
Previous (March 2020) forecast

% change unless otherwise specified	2017	2018	2019	2020	2021	2022	2023	2024+
Real GVA	0.8	1.4	0.6	-6.3	4.4	1.0	0.6	0.6
RPI	3.1	3.9	2.9	1.2	2.2	2.5	2.5	2.6
RPIY	3.2	3.6	2.6	1.4	2.2	2.4	2.4	2.5
Nominal GVA	4.1	5.9	3.9	-5.1	6.0	2.7	2.8	3.1
GOS (including rental)	-0.3	7.5	4.3	-8.2	7.7	2.2	2.5	3.2
Financial services profits	*-6.4*	*9.6*	*2.0*	*-2.0*	*5.0*	*2.9*	*2.9*	*3.4*
Compensation of employees	8.1	4.6	3.6	-2.5	4.6	3.1	3.0	3.1
Employment	2.3	1.4	1.0	-2.9	2.8	0.8	0.5	0.4
Average earnings	2.6	3.5	2.6	-0.6	2.2	2.3	2.5	2.7
Interest rates (%)	0.3	0.6	0.8	0.2	0.2	0.3	0.4	0.6
House prices	2.9	7.1	7.0	-10.0	5.0	4.0	3.0	2.7
Housing transactions	7.8	5.3	-1.8	-50.0	45.0	15.0	7.0	1.5

Changes since last forecast

percentage point change	2019	2020	2021	2022	2023	Trend
Real GVA	0	-1.2	-1.4	+0.9	+0.5	0
RPI	0	+0.1	-0.7	-0.1	0	0
RPIY	0	+0.1	-0.8	-0.1	0	0
Nominal GVA	0	-1.2	-2.1	+0.5	+0.1	0
GOS (including rental)	0	-4.7	-0.6	+1.0	+0.1	0
Financial services profits	0	-16.6	+3.0	+3.1	+1.1	0
Compensation of employees	0	+1.9	-3.1	+0.1	+0.1	0
Employment	+0.2	+1.3	-1.6	+0.1	+0.1	0
Average earnings	0	+0.9	-1.1	0	0	0
Interest rates (%)	0	0	-0.3	-0.4	-0.5	-0.6
House prices	0	+10.0	-7.0	-1.3	-0.3	0
Housing transactions	0	+30.0	-35.0	-13.5	-5.5	0

Annex 2: Illustrative shape of FPP forecast



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

Annex 3: Letter from the Treasury and Resources Minister

Minister for
Treasury and Resources

Government of JERSEY

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Dame Kate Barker

Chair of the Fiscal Policy Panel

31st July 2020

Dear Dame Kate,

I understand that the Fiscal Policy Panel is working to update its economic assumptions and advice with planned publication in early August, with your annual report following later in the year that can consider the draft Government Plan.

The updated economic assumptions and advice published 23 March 2020 set out very clearly the unprecedented uncertainty in the global economy brought about by the impact of Covid-19, and damaging effects it would have on the Jersey economy and the fiscal position. We are grateful for this timely and significant revision to prospects for the Jersey economy, noting in particular the emphasis of the Panel on not only the short-term consequences in a cyclical downturn but also the risks of long-term structural weaknesses as the economy recovers.

Acknowledging the value of the advice from the Panel in March the Government of Jersey has put in place, and continued to develop and extend, a range of exceptional policy measures to support the economy as you recommended. In addition, the Government has followed your advice to put in place a fiscal stimulus package that is timely, targeted and temporary. As Treasury Minister my priority and key responsibility is the government finances for Jersey, and while I have approved extraordinary expenditure to protect the island's economy in the short term my focus remains also on sustainable government finances in the medium to long term, recognising that economic success is crucial to this aim.

I would be grateful to receive the advice of the Panel ahead of finalising the draft Government Plan including advice on the pace of any fiscal consolidation throughout the next Government Plan as support and stimulus is withdrawn, and also the extent of any risk of a structural imbalance/deficit in the Government finances if the economy recovers as expected. In managing the unprecedented revenue and expenditure pressures created by the global pandemic and recession in our island economy we have secured borrowing to provide the Government with flexibility in our financing. We also have considerable infrastructure costs in coming years to catch up on previous under investment as well as for a long overdue new hospital.

In managing both sides of the balance sheet e.g. the assets in the Strategic Reserve and the liabilities from borrowing I have to consider the trade-offs between drawing down reserves and borrowing. Advice from the Panel on managing these issues to ensure the resilience and sustainability of the Government finances would be invaluable as we consider the financing needs of the next Government Plan.

Minnistre d'la Trésor'rie et du Bein Publyi — Gouvèrnément d'Jèrri

Yours sincerely

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