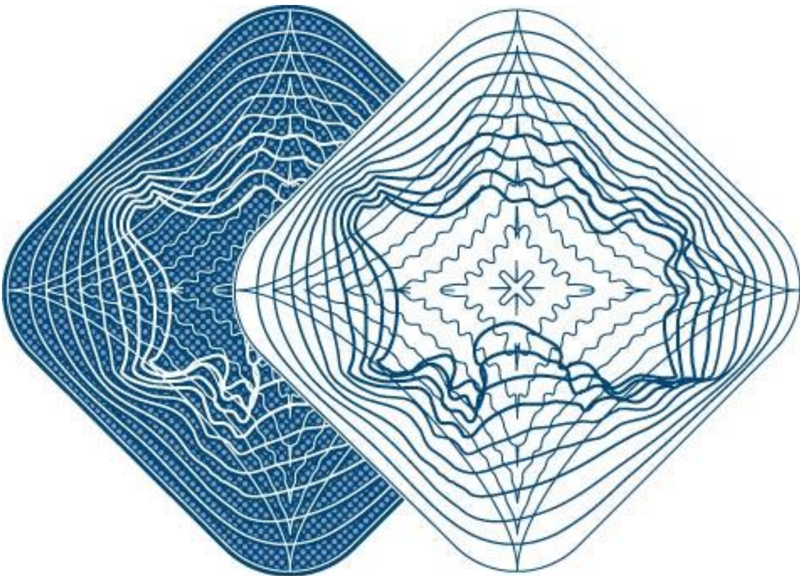
# Jersey's
# Fiscal Policy Panel
# Update
July 2016



## Introduction

This short update report has been prepared in response to a letter from the Treasury and Resources Minister on 24 June 2016 (included as Appendix 1) asking the Fiscal Policy Panel (FPP) to consider whether the outcome of the UK referendum on EU membership requires the Panel to update the advice previously set out in the 2015 Annual Report and letter to the Treasury and Resources Minister in March 2016. In particular, the Panel has been asked to consider whether the advice with respect to the economic outlook and/or the appropriate approach to fiscal policy during the current Medium Term Financial Plan (MTFP) period needs to be changed.

The FPP welcomes the opportunity to update the previous advice after such a significant development and believes the decision to seek advice indicates a continued transparent approach to fiscal policy in the Island.

At this point the Panel's advice is to continue to implement the MTFP in line with previous FPP advice to offer support for the economy in the short term but aiming to return the current budget to balance by 2018/19. This advice will be updated in future Annual Reports (the next one will be published in August) and in the meantime the emphasis should be on ensuring that the MTFP has sufficient flexibility to be able to adapt to the different economic scenarios set out in this update, and on considering what contingencies might need to be introduced. In addition, the Panel would urge focus on delivering the existing capital programme on time and in a way that supports the Jersey economy (especially as on the recent FPP fact-finding visit there were indications that the construction sector was further from full capacity than previously expected).

It is hoped that this update is both timely and helpful for Ministers and States Members in advance of the MTFP Addition debate. However, it should be recognised that this remains a period of significant uncertainty, and fiscal policy may need to be kept under review.

## Economic impact of Brexit

Brexit may affect the Jersey economy through three main channels:

1. Short/medium-term uncertainty

The financial and economic impact of the referendum result can already be seen through the large increase in uncertainty it has created. Most forecasters have significantly revised down their UK growth forecasts for the remainder of this year and for 2017 such that the average forecast for 2016 is now about

0.5% lower and for 2017 1.8% lower than forecast before the UK's referendum. These reductions mean that the UK economy is expected to be in recession or near recession over that period. This will have a negative impact on Jersey.

At the same time the substantial decline in the sterling exchange rate – if maintained - means that, on the basis of the Bank of England's 'rule of thumb' for exchange rate changes, inflation is expected to rise to around 3 to 4% over the next two years in the UK. Despite higher inflation, the Bank of England has already announced some stimulus measures by reducing banks' capital requirements. While the July meeting of the Monetary Policy Committee kept Bank Rate on hold, the minutes stated that "*in the absence of a further worsening in the trade-off between supporting growth and returning inflation to target on a sustainable basis, most members of the Committee expect monetary policy to be loosened in August*". If this results in a fall in the Bank Rate, it could have an adverse effect on Jersey since at very low rates the role and profitability of financial intermediaries may diminish.

On the other side, a weaker exchange rate will help businesses that export to non-sterling countries (or compete with firms from non-sterling countries) to be more competitive. However, the impact of this on the export of financial services may be limited.

2. Long-term impact on the UK, with spillovers for Jersey

Although the uncertainty effect is considerable, its impact is temporary and so more important is the long-run effect on trade and other cross-border transactions created by Brexit. At the moment, the overall scale of this long-run impact is unknown, not least because the exact nature of the UK's relationship with the EU post-Brexit is still unknown. However, estimates produced by the Centre for Economic Performance (CEP) at the London School of Economics[1] set out a plausible view of the implications for the UK economy. This suggests that:

- The expected fall in trade between the UK and EU will result in a 1.3% to 2.6% decline in UK GDP (depending on the terms of UK withdrawal) relative to a scenario where the UK remained in the EU. They argue that this decline could then be magnified by resultant effects on UK productivity (trade and other cross-border transactions

[1] BREXIT 2016: Policy Analysis from the Centre for Economic Performance, Paper No' CEPBREXIT08, June 2016
http://cep.lse.ac.uk/pubs/download/brexit08_book.pdf

including foreign direct investment are an important source of productivity growth) causing an overall long-term reduction of GDP of between 6.3 and 9.5%.

- The CEP also point out that financial services is a big beneficiary of inward investment and that activity in this sector in the UK could also fall.
- There will also be some long-term adverse effects for EU countries, but these are likely to be considerably smaller.

Given that financial services are likely to be one of the most adversely affected sectors post-Brexit, there may be spill-overs to Jersey, though the scale of these is so far unclear.

The above is only one of a range of estimates. The economic implications are unlikely to play out exactly as this economic modelling might suggest. Nonetheless the Panel would expect the period of negotiations and resultant withdrawal of the UK from the EU to worsen the UK's economic prospects in the short and long term. This will be compounded in the short term by financial market volatility and general uncertainty which will weigh on business and consumer decisions.

3. Longer-term impact on Jersey

As well as a re-negotiation of the UK's relationship with the EU, there is a risk that Brexit will result in a change in Jersey's terms of access to the EU. Whilst there are a number of reasons to be optimistic that such a change will not occur, it is clear that any re-negotiation of Jersey's position would probably be detrimental to the long-run prospects for the Jersey economy.

## Potential implications for fiscal policy

In weighing up the implications of these probable economic trends for Jersey's Medium Term Financial Plan and the approach to fiscal policy it will be important to distinguish between cyclical and structural impacts.

Scenario 1

If economic activity is dragged down significantly on a purely cyclical basis it would be worth looking at ways to support the economy and possibly to a greater extent than is currently envisaged in the MTFP. Figure 1 shows for illustrative purposes how the outlook changes under an indicative Scenario 1 where economic output (as measured by GVA) falls in 2017 to 5% below the

FPP's previous estimate of the potential, or trend, level of GVA (i.e. the level of output consistent with full non-inflationary use of resources) before recovering somewhat to 3% below potential by 2019. This compares to the economic assumptions from March 2016 that GVA would be just 0.5% below its potential level in 2017, recovering to be equal to the potential level by 2019.

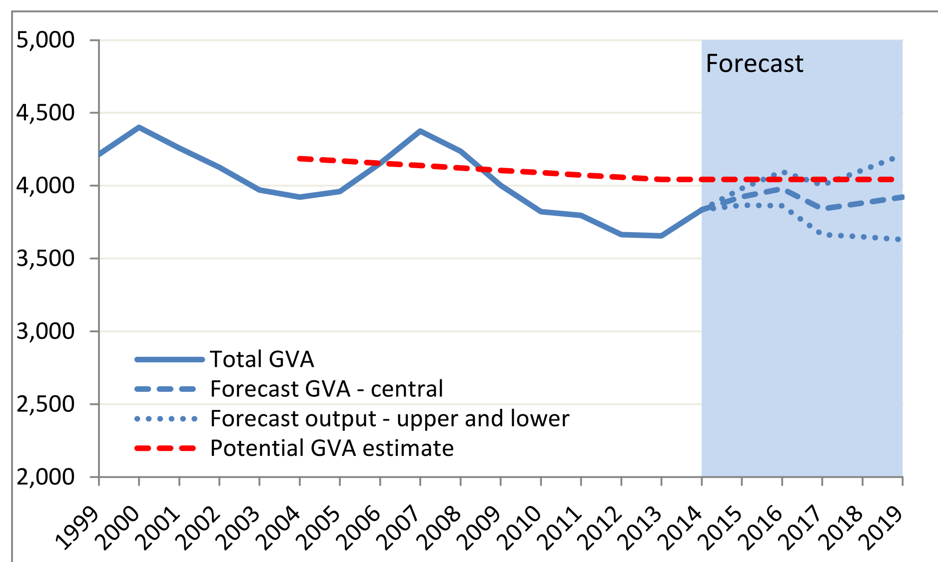
In this scenario, the degree of spare capacity in the economy (i.e. the gap between actual GVA and potential GVA) increases in the short term and the economy does not return to capacity in the MTFP period. This could mean that additional support to help minimise the fall in GVA and any wider impacts on employment is required in 2017 and 2018. What type of intervention might be justified and under what circumstances is discussed in more detail below. In addition, under this scenario the most appropriate time to balance the current budget is no longer 2018/19 as there is still significant spare capacity in the economy in these years and the most appropriate time to do so would therefore be outside the MTFP period.

**Figure 1**

**Scenario 1: 5% cyclical decline in 2017**

GVA levels £000s, 2013 prices

Source: States of Jersey Statistics Unit/FPP calculations




Scenario 2

A different approach would be required if the economic impact of the UK leaving the EU were such that it has little impact in the short term but has a more significant impact on the potential output of the economy i.e. a structural impact. Figure 2 shows for illustrative purposes Scenario 2 where the structural impact manifests itself in a 5% fall in potential GVA in 2017.

Scenario 2 leads to a situation where the economy reaches capacity sooner and at lower level of GVA. What this implies for the MTFP is that rather than using fiscal policy to give additional support to the economy, the approach

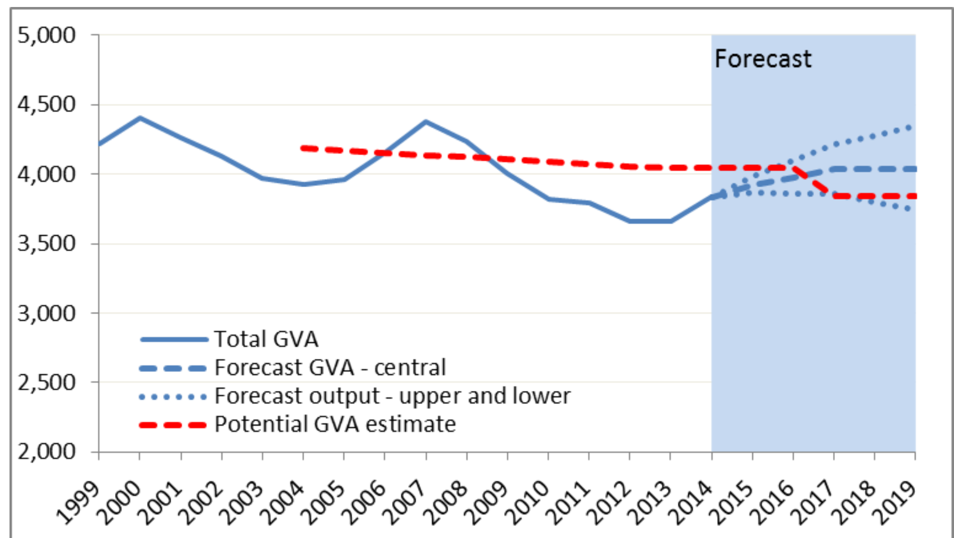
should be to look at further reductions in expenditure or increases in revenues to bring the budget closer to balance. Under this scenario the short-term economic performance is not affected as there is no cyclical impact of Brexit and there is less concern about the contractionary impact of fiscal tightening on the economy. Moreover, the economy moves above capacity quicker than previously expected and it is entirely appropriate that fiscal policy is tighter under such circumstances.

**Figure 2**

**Scenario 2: 5% structural decline in 2017**

GVA levels £000s, 2013 prices

Source: States of Jersey Statistics Unit/FPP calculations




Scenario 3

The most likely outturn at present seems to be that Jersey may experience a combination of cyclical and structural impacts over the course of the next few years as a result of the UK's decision to leave the EU. Figure 3 illustrates what both a cyclical and structural decline in economic performance in 2017 would look like. Under this scenario short-term economic performance is impacted but because the underlying trend level of GVA is also dragged down the economy continues to be close to capacity in 2018/19, albeit at a lower level than previously expected.

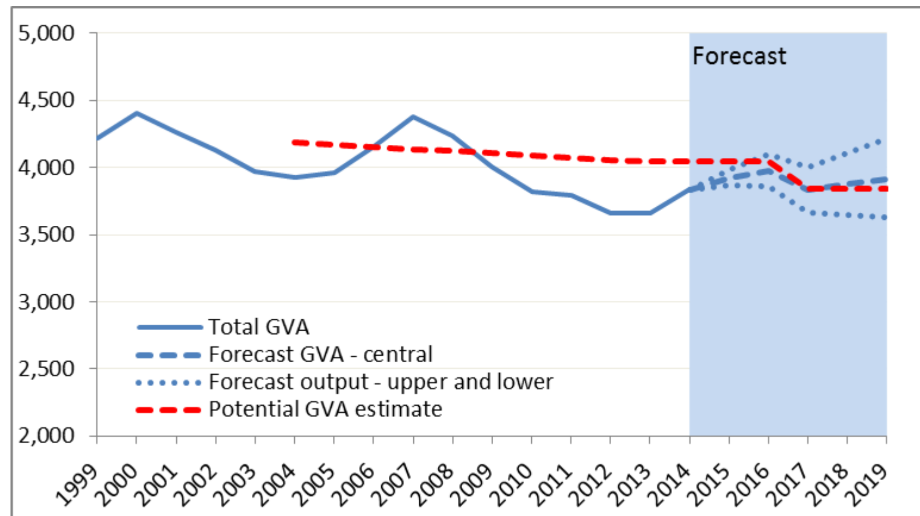
Scenario 3 could therefore result in circumstances where additional fiscal support could be appropriate in the short term but further reductions in expenditure or increases in revenue will be required in future years as States revenue is on a lower trajectory than previously thought. Under this scenario it will be important to determine the extent of the cyclical and structural impacts before establishing the most suitable approach. A significant degree of judgement will be required and that could involve additional FPP advice as the trends in both the UK economy and Jersey become clearer, and as the UK's negotiations with the EU start to progress.

**Figure 3**

**Scenario 3: 5% structural decline and 5% cyclical decline in 2017**

GVA levels £000s, 2013 prices

Source: States of Jersey Statistics Unit/FPP calculations




## The right approach for the MTFP

At this point, so soon after the referendum, the economic implications of Brexit for the Jersey economy are unclear. Before the results of the UK referendum were known, the Panel had found on their June fact-finding visit that the Jersey economy was performing more strongly than previously thought. There were emerging signs of capacity constraints within the local economy, particularly in the labour market.

Since then, risks have clearly increased significantly to the downside and the Jersey economy is likely to feel the impact of the sustained period of economic and financial market turbulence. Overall these more positive trends followed by a negative shock would suggest that at this juncture it is not appropriate to take a decision to change the overall approach in the MTFP of supporting the economy in the next couple of years but gradually moving to balance the current budget in 2018/19. A sensible approach is to maintain course until there are clearer indications of how the Jersey economy is being and will probably be affected.

If the economy does show signs of weakening the first response should be simply to allow the automatic stabilisers to work (i.e. allowing spending on some benefits to naturally increase and tax revenue on earnings and profits to naturally fall to offer some initial support to the economy without making any explicit policy changes). If this has cash flow implications for the States' financial position they should be managed initially by drawing on reserves rather than changing taxation or spending plans. Given that the Stabilisation Fund has been fully spent supporting the economy in the aftermath of the

global financial crisis, drawing on reserves would need to be based on careful decisions about long-term sustainability, balancing with short-term needs.

While no action is required immediately, it will be vitally important that flexibility is built into the MTFP to allow fiscal policy to adjust in what are uncertain times for any negative impact on the local economy from Brexit. This flexibility is needed in both directions:

- Firstly, the ability to add further support to the economy if the Island economy performs well below what is currently expected and employment is materially affected.

- Secondly, recognising that any structural impact on the future performance of the economy could manifest itself in lower revenue for the States and require further reductions in expenditure or increases in revenues to bring the budget closer to balance.

It is important to consider now how to react in the circumstances where the FPP advise that either or both of the above approaches is necessary. Each situation is discussed in more detail below.

*Further fiscal support*

Should short-term fiscal support be appropriate it will be important to ensure that any proposals are consistent with the 3Ts i.e. are timely, targeted and temporary. In the past the FPP have advised to look first at capital expenditure that is necessary at some time, and brings economic benefit in its own right. This still applies today but given the significant amount of capital expenditure already planned in the MTFP it may be that it is hard to find suitable projects that satisfy the 3Ts and/or can be delivered from local capacity. Given the risks of delay in capital projects, however, it would be important to ensure that current projects are delivered on time to ensure that the planned stimulus is actually delivered.

Capital expenditure of this type helps to mitigate concerns about leakage which is inevitable in a small open economy like Jersey. Alternative fiscal measures to support the economy all have some risk of benefits leaking outside the local economy (for example through spending on imports) and have other risks associated with them. Looking at some of the main options in turn:

- A reduction in GST may not be passed on fully to consumers and is not well targeted as it benefits everyone – those on low and high

incomes and residents/visitors alike. Further, it may prove politically difficult to increase the rate of GST back to its previous level, putting fiscal consolidation at risk.

- Income tax changes do not benefit those who do not pay tax and are difficult to make timely because of the lags in the tax system.

- Employee social security contributions only impact on those who have employment income and could have implications for the Social Security Fund.

Another way of looking at how to support the economy would be to consider whether any of the tightening measures already set out in the MTFP could be slowed or introduced with a slight delay in a way that is consistent with the 3Ts and which would mean they are more effective than any of the options considered above. It will be important to fully assess the fiscal situation and the specific nature of the economic shock hitting the economy before determining what, if any, is the most appropriate response.

*Further fiscal tightening*

As this would be required to address a permanent impact on States finances, there will need to be consideration of measures that deliver a lasting change to fiscal policy.

This will require assessing what can be achieved and in the timescales required both in terms of additional revenue raising and/or reductions in government spending. Consideration could be given to measures in the MTFP that could be increased or introduced more quickly. Preparing the groundwork and understanding what needs to be done to implement specific measures should be done in advance.

## Next steps

Future FPP advice will be important in determining whether any of the above are required and if so, what may be most suitable given the nature of the economic shock. As ever the Panel stress that, under any scenario, driving efficiency in public services is beneficial to the economy and should be pursued with vigour.

At this stage, the FPP are not recommending any changes to the economic assumptions from March 2016. The Panel have reviewed the assumptions but

do not believe there is sufficient information available at this time to make a coherent set of revisions, although it is clear that the referendum result has the potential to have an impact on growth, inflation and monetary policy assumptions. The increase in uncertainty since the UK referendum makes the range around the forecasts more significant – with the balance of risks having clearly shifted towards the downside. However, the MTFP sets a clear path for fiscal policy for the next few years and ad hoc adjustments to that path should not be made while the impacts of the UK's referendum remain so uncertain. The Panel will look at this question again when the 2016 Annual Report is published in August.

## Appendix 1: Letter from the Treasury and Resources Minister

**Minister for Treasury and Resources**
P O Box 353, Cyril Le Marquand House, The Parade
St Helier, Jersey, JE4 8UL
Tel: +44 (0)1534 445502

Dame Kate Barker

24 June 2016

FPP Chair

Dear Dame Barker

It was good to meet the FPP again on your recent fact finding visit and to update you on progress regarding the MTFP Addition. The discussions we had with you and our planning at that time were very much based on the economic outlook and advice from the FPP as set out in your letter to me in March 2016.

The momentous decision taken yesterday by the British people to leave the European Union is quite clearly something which has the potential to alter the short and longer-term performance of the UK economy. While the implications for financial markets and the UK and global economies are unclear the impact on the Jersey economy is even less certain.

The MTFP was already framed against a period of economic uncertainty and the UK's decision will heighten this uncertainty. While it may be too early to consider the implications for the Jersey economy I would like to ask you to consider updating the letter and advice you sent to us in March. In particular, whether it is your view at this stage that there is a reason to change that advice both in terms of the economic outlook and/or your advice to continue to support the economy in the short-term and plan to balance our books by 2018/19.

I think it would be useful for the Council of Ministers and States members to have an update of this nature by the middle of July if you thought that was practical.

I look forward to hearing from you.

Yours sincerely

**Senator Alan Maclean**
Minister for Treasury and Resources

direct dial: +44 (0)1534 440672
email: a.maclean@gov.je
www.gov.je