

STATES OF JERSEY



ANTI-INFLATION STRATEGY

**Presented to the States on 11th February 2008
by the Minister for Treasury and Resources**

STATES GREFFE

A NEW ANTI-INFLATION STRATEGY FOR JERSEY

This new anti-inflation strategy is presented to the States by the Ministers for Treasury and Resources and Economic Development. It is designed to update the current States anti-inflation strategy which is now 7 years old. The approach taken is to examine the nature, causes and costs of inflation in Jersey and develop a strategy that will address the fundamental issues for a small island economy like ours.

The conclusion is very much that there are no quick wins or easy options in controlling inflation and that many of the key ingredients for an anti-inflation strategy are already in place. The new strategy is about building on current policies and strengthening them rather than introducing new initiatives. There is a window of opportunity for the Island created by favourable global inflation trends and the success the Island has had in reducing inflation in recent years. This strategy aims to seize that opportunity and attempt to lock Jersey into low inflation.

The new Strategy puts forward 9 areas for action. Key points include to–

- Retain the current inflation target of 2.5% for RPIX.
- Set policy relative to the economic cycle and undertake the appropriate research to do so.
- Set fiscal (tax and spending) policy following guidance from the Fiscal Policy Panel and develop the new Fiscal Framework further on their advice.
- Review the effectiveness and resources of the Jersey Competition Regulatory Authority (JCRA) and the Jersey Consumer Council (JCC).
- Examine whether the Regulation of Undertakings and Development Law (RUDL) can be applied in a manner that better facilitates productivity improvements and competition.
- Charge Economic Development with the long-term objective (beyond the current Economic Growth Plan) of delivering productivity improvements across the economy.
- Consider how the new Island Plan can facilitate productivity improvements and better take account of market signals.
- Review the impact of States housing policies on housing demand in the Island.
- Raise awareness and understanding of inflation in the Island as everybody – employees, employers and the States – has a role to play in controlling it.

Summary

The attached paper looks at what inflation is, the main causes of inflationary pressure, the costs of inflation and the experience in the global economy, UK and Jersey. Drawing from this analysis this summary sets out what the key ingredients of an anti-inflation strategy should be for Jersey. It represents a framework within which policy should be developed.

What is inflation?

Inflation is a general rise in prices across the economy. The inflation rate is a measure of the average change in prices across the economy and is normally measured by the percentage change in the retail (or consumer) price index.

A rise in the price of any particular good or service can influence the rate of inflation but this not the same as a rise in the inflationary pressure in the economy.

The real inflationary danger in an economy is a build-up of inflationary pressure which occurs when the overall level of demand for goods and services exceeds the ability of the economy to supply them.

There are 2 primary causes of inflation: firstly, demand-pull inflation where the level of demand rises above the level of supply; secondly, cost-push inflation where the supply base contracts below the level of demand due to a rise in costs such as wages and/or input prices.

The costs of inflation

Experience across the Globe has shown that high inflation can undermine economic growth and leads to volatile economic cycles of boom and bust. In particular as far as Jersey is concerned, high inflation will –

- undermine economic efficiency – and therefore economic growth;
- reduce the competitiveness of export businesses;
- make Jersey a less attractive place to do business and live.

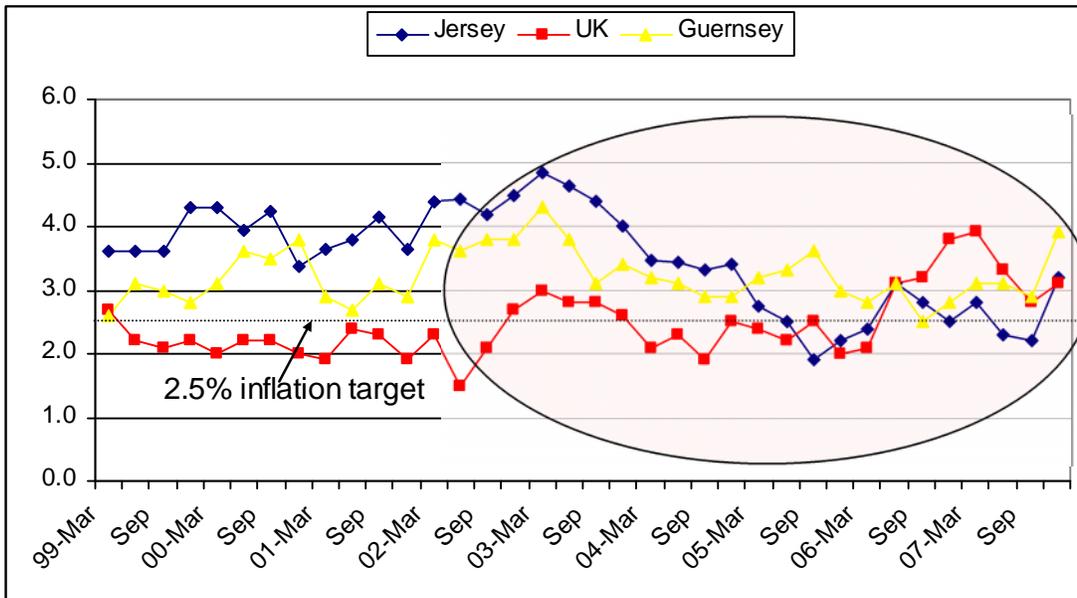
Global inflation trends

There has been success across the globe in the last 15–20 years in reducing inflation as a result of better policy-making, globalisation and stable economic conditions (see Chart 4). This success was reflected in trends in the UK (and France) and more recently in Jersey.

The global inflation outlook and the recent trends in Jersey (shown in the chart below) provide a window of opportunity to ensure that policy in Jersey locks into this low inflation environment and even if some of the favourable trends go into reverse.

Chart 1: Sustained fall in Jersey inflation

% change in RPIX



Source: States of Jersey Statistics Unit/National Statistics

Complacency because there has been success in Jersey in reducing inflation in recent years would be a grave mistake. Experience shows that inflation trends can quickly change and inflation can take hold, bringing with it all the problems described above.

The aim of this new-anti-inflation strategy is to lock in the improvements that we have seen in inflation in Jersey and lay solid foundations for the Island's future economic success.

The key components

1. An inflation target

The previous anti-inflation strategy agreed by the States in 2000 adopted an inflation target of 2.5% for RPIX (retail prices index excluding mortgage interest payments).

There has been considerable success across the world economy with inflation targeting, although this has been as a target for monetary policy. Although Jersey does not have its own monetary policy (because it is in a monetary union with the UK) an inflation target is still an important part of anti-inflation policy. This is because it acts as an anchor to which people can refer, and provided that it is backed by credible policies will also help to keep expectations about inflation in check. Without an explicit inflation target, people and businesses are less aware of what policy is trying to achieve and this may even mean that anti-inflation policy is less effective. The intention is not to meet the target at all times (even economies with control over their own interest rates do not attempt to do this) but the aim to keep inflation close to target over the medium-term.

The previous target of 2.5% is consistent with an approach that focuses on price stability, the ultimate aim of inflation policy. The fact that it has been the target for the last 7 years also means that policy will benefit from consistency from continuing with the same target.

RPIX is also the right index of retail prices to target in general because it excludes the impact of interest rates which can create distortions in the measure of inflation. For example, in the short-term higher interest rates push up RPI and this could be interpreted as higher inflation, but in reality the higher rates will act to keep inflation under control and help meet the inflation target.

The UK moved from targeting RPIX to a new index, the Harmonised Index of Consumer Prices (CPI) in December 2003. On average, RPIX in the UK has exceeded CPI by 0.7% between 1989 and 2007. This suggests that there could be some potential benefits from moving to CPI in Jersey. However, with a host of new inflation measures just introduced (RPIY, RPI low income and RPI pensioners) further consideration should be given to the potential benefits, the differences between the 2 measures, costs in terms of resources required to produce another index and risks to transparency from changing index and target.

Action 1: Retain the current States inflation target of 2.5% for RPIX over the medium-term.

Action 2: States Economic Adviser and Head of Statistics to report to the Council of Ministers in first half of 2008 as to the advantages and disadvantages of producing a new CPI (including resource implications) and using it as the target measure of inflation.

2. Managing balance between overall demand and supply

(a) Understanding the economic cycle

The analysis in this paper (section 3.1) shows that the critical issue in managing inflation in an economy is to get the balance right between the overall level of supply and demand in the economy. Policy needs to be set according to whether the economy is operating with spare capacity (supply is greater than demand) or excess demand (demand exceeds supply). Where the economy is in the economic cycle and the degree of spare capacity are primary issues in determining anti-inflation policy.

To date, no detailed research has been done on the Jersey economic cycle and the degree of spare capacity in the economy at different stages in the cycle. This is a prerequisite for anti-inflation policy.

Action 3: Economic Adviser to undertake in 2008 research on the economic cycle and degree of spare capacity in the Jersey economy and ensure it can be monitored on an ongoing basis.

(b) Managing demand in the economy

Fiscal Policy

P.133/2006, which was agreed by the States in October 2006, set out a new Fiscal Framework, which had as one of its key objectives meeting the States inflation target. The analysis in this report shows that government expenditure is a key contributor to aggregate demand and therefore inflationary pressure when there is little or no spare capacity in the economy. The new Fiscal Framework is designed to ensure these economic issues are given detailed consideration when setting tax and spending policy.

The new Fiscal Policy Panel (FPP) will feed independent high level economic advice from 3 top economists into the annual budget process ensuring that economic considerations are given full attention. The objectives are that the Framework will lead to a more transparent and credible process for making tax and spending decisions in the Island. It will also help ensure that fiscal policy is set to be more countercyclical and therefore maximise the economic potential of the Island, but also help meet the inflation target.

The Framework incorporates the Stabilisation Fund, with the Minister for Treasury and Resources responsible for its operation, but having regard to the advice of the new independent FPP. The role of the FPP is to publish an annual report in September each year for the Minister for Treasury and Resources that –

- Examines the strength of the Jersey economy, the position in the economic cycle and the outlook for the Jersey/world economies.
- Comments on the appropriateness of the States financial position/forecasts given the above.
- Recommends policy regarding the Stabilisation Fund and whether economic conditions justify payments to or from the Fund and gives guidance on their size.
- Considers if payments are to be made what would be the best way to achieve them.
- Outlines when the Stabilisation Fund may be at sufficient levels and therefore when payments should be made into the Strategic Reserve.

The new Fiscal Framework is therefore the key ingredient of the new anti-inflation strategy. In a small island economy with limited spare capacity, due to the tight land and labour constraints, getting fiscal policy right and ensuring that it does not add to inflationary pressure at critical times in the economic cycle should be the primary aim. With no control over interest rates it should be the first objective of any anti-inflation strategy.

Fiscal policy must be set with reference to the degree of spare capacity, the position in the economic cycle and the level of real interest rates in the economy. The work undertaken as Action 3 will help to provide the FPP with the information they need.

Structure of demand

In setting policy it is also important to recognise that Jersey is an economy where just over 50% of activity is financial services (with a high proportion of other activity directly related to this) and that export demand is the key driver of economic activity. The nature of the financial services industry is such that it can go through periods of very strong growth – recently it has been growing in real terms at 12% – and this can feed directly into the other components of overall demand (increasing the risk of inflationary pressure), namely –

- **consumption** – through wages (including bonuses) and employment growth;
- **government expenditure** – through increases in tax receipts;
- **investment** – both directly and by other industries that are linked to it.

Without control over interest rates the States has few tools at its disposal to manage these upturns in demand. Clearly the primary aim has to be to ensure that the combination of tax and government expenditure does not add to excess demand in the economy at certain stages of the economic cycle. The new Fiscal Framework is set up to achieve just this, but it will be important that the States, businesses and individuals all work to ensure that these upturns do not feed through into higher costs and prices.

Interest rates

The analysis in section 3.2 of this report shows that, because interest rates in the Island have been set relative to economic conditions and inflation trends in the UK, at times they have not been helpful in controlling inflation in Jersey. This is because the economic cycles in the UK and Jersey are not closely aligned and that the extent of spare capacity in each economy is not closely aligned as a result.

The analysis shows that rather than just accepting that interest rates are out of the Island's control, that the appropriate approach is to ensure that the balance of policy between interest rates and fiscal policy are set relative to the economic conditions in the Island. The new Fiscal Framework including the Fiscal Policy Panel is designed to help achieve this and the advice of the Panel will be a vital ingredient.

Action 4: Treasury and Resources Department, Economic Adviser and Fiscal Policy Panel to review the new Fiscal Framework by early 2009 following the publication of the FPP's first report to see if it can be improved to better meet these objectives.

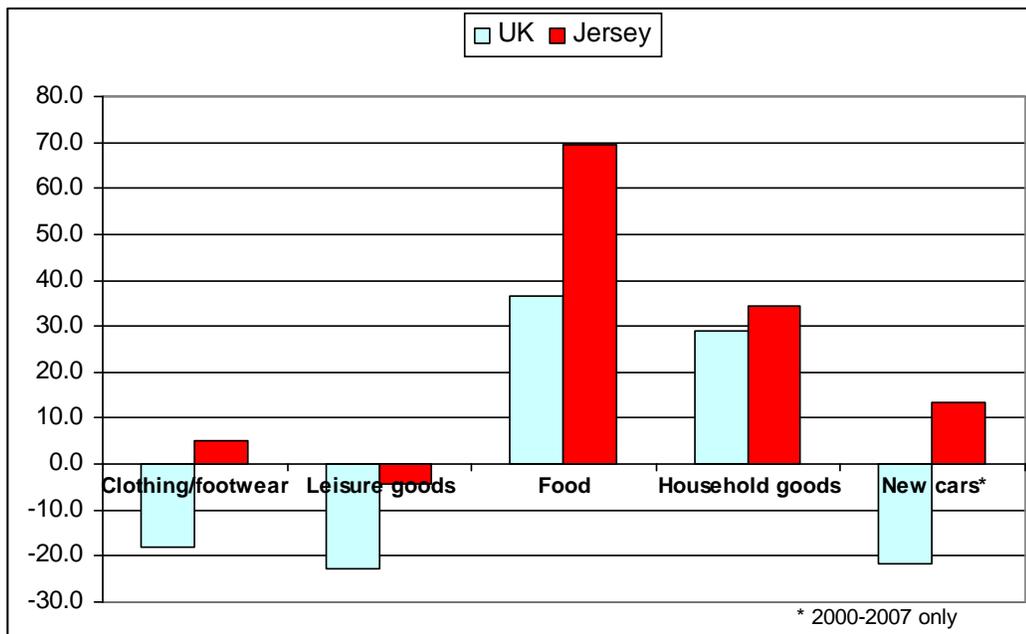
(c) Supply side

Competition

Section 3.3 in this report shows that the UK's experience in the 1990 and 2000s and recent experience in Jersey (see chart below) illustrate the important role competition can play in keeping inflation under control. Ensuring there is vigorous competition between firms helps keep inflation down and is critical to maximising productivity and economic growth. Competition encourages firms to improve efficiency and innovate, puts downward pressure on costs and improves the organisation of production. All these factors combine to help keep inflation under control and the end result is a better deal for consumers.

Chart 2: Favourable trends in UK not reflected in Jersey

% change in price index 1991–2007



Source: States of Jersey Statistics Unit/National Statistics

There has been a stream of economic research looking at the benefits of competition which shows that it is closely linked to dynamic and efficient markets. Research has shown that –

- Competition can have a positive impact on efficiency and productivity

- Market power tends to reduce the rate of innovation and productivity growth
- Increased market concentration is associated with reduced efficiency
- Entry and exit of firms in the market place can help productivity growth
- New businesses tend to bring higher rates of productivity
- Firms that face strong domestic competition perform better in export markets

The previous anti-inflation strategy aimed to ‘develop policies for introducing more competition in the Island’s product markets’. A big step has been taken since then with the introduction of the new Competition Law. However, the role of the Jersey Competition Regulatory Authority (JCRA) is critical in ensuring the Law is effective.

Experience elsewhere and recently in Jersey highlights how public pressure and consumer representation can also achieve results in terms of making markets work and keeping prices down.

Action 5: Minister for Economic Development to review in 2008 the effectiveness and resources of the JCRA and JCC in achieving the overall objective of increased competition.

Regulation of Undertakings and Development Law (RUDL)

Allowing markets to work efficiently is an important part of creating the conditions for competition to prevail. Somewhat uniquely, the Island has RUDL which can influence the effective operation of product and labour markets. RUDL can affect the level of competition in the Island through allowing (or preventing) firms to enter the market. Given the important role competition has in meeting the Island’s economic objectives of low inflation with economic growth, RUDL must be applied in a manner that gives full consideration to the implications of decisions on competition.

RUDL also impacts on the operation of the labour market in the Island. This is because businesses need an RUDL licence to employ people in the Island. The efficient operation of labour markets is an important aspect of keeping costs under control and preventing cost-price inflationary spiral. RUDL has a number of objectives including managing the pressure on the Island’s resources and maintaining competition. It is important that it also operates in such a manner as to allow the labour market to operate efficiently.

Action 6: Minister for Economic Development to bring forward proposals in 2008 on how RUDL can operate more effectively in helping the Island to meet its economic objectives and in particular facilitate productivity improvements, competition and a freely functioning labour market.

Availability of resources

As the analysis in the paper shows, inflationary pressure is the result of the interaction of the overall level of demand and supply in the economy. Policies that can help to increase the supply side of the economy can mean that for any given level of demand, inflationary pressure is less likely to build up.

One way to facilitate supply side improvements is by increasing the amount of resources available whether it is land, labour or capital. For small island economies like Jersey this is difficult to achieve to any great extent as the amount of resources at the Island’s disposable are restricted by –

- its relatively small size;
- population policy;
- the need to protect countryside and coastal areas.

Opportunities like the Waterfront which through land reclamation bring new areas of land into economic activity are rare, but the benefits clear to see in terms of boosting the Island’s supply capacity. Where there are further opportunities such as ‘East of Albert’ there could be some scope for further supply side improvements.

The consultation and formation of the new Island Plan will also be important in determining what land is available for economic use over the next 15 years.

Section 3.5 shows how the period of sustained economic growth and low inflation in the UK in the 1990s and 2000s has been built on sustained inward migration, growth in the working age population and employment and in contrast to the trends seen in Jersey over the same period.

The consultation process around *Imagine Jersey 2035: preparing for the future* will consider the direction the Island wants to take going forward in terms of population policy and the availability of people of working age. Once the Island has decided what the direction should be, the primary focus in terms of supply side issues will be using the land and labour the Island has at its disposal to the maximum effect.

Work already underway on the new Island Plan, Imagine Jersey 2035 and further development of the Waterfront will be critical in determining the supply capacity of the Island in the future and hence its ability to manage inflation.

Using resources efficiently

Once the Island has determined what is acceptable in terms of inward migration and land use, the emphasis for delivering supply side improvements is on making better use of the resources at our disposal, i.e. productivity improvements. That is, producing more with the same resources.

Section 3.5 shows that the UK's success in the 1990s and 2000s in keeping inflation under control has been built on sustained employment and productivity growth. The States Economic Growth Plan sets out how the Island can deliver productivity improvements. The focus is on all the key components of productivity growth, namely –

- skills
- investment/infrastructure
- innovation
- competition
- enterprise and
- macro-economic stability.

These key building blocks for productivity need to be at the centre of Economic Development Department policy beyond the life of the current Economic Growth Plan and into the long term if supply side improvements are to underpin future economic growth and keep inflation under control. Planning policy is recognised across the world as being a constraint on productivity – the new Island Plan must reduce this barrier to productivity growth but without jeopardising wider social, environmental and design objectives of the Plan.

Action 7: Sustained productivity growth to be the long-term objective of the Economic Development Department beyond the life of the current Economic Growth Plan.

Action 8: Minister for Economic Development in 2008 to advise Minister for Planning and Environment how the new Island Plan can facilitate productivity improvements and better take account of market signals.

(d) Housing policy

Trends in the housing market are examined in section 3.6. They can have a significant impact on inflation in the Island as they feed directly into the RPI and can also influence demand and supply in the economy overall. Higher house prices can bolster demand in the economy through wealth effects, but can also impact on the supply side through wage demands and labour mobility.

The improvement in inflation in Jersey in recent years has been accompanied by lower house price inflation. While it should not be taken that the two are directly linked (both will be affected by the economic cycle for

example) it will be important to maintain a balance between housing demand and supply going forward. The recent rise in house prices, the high level of house prices relative to earnings and concerns about affordability for first-time buyers all serve to emphasize the need to ensure that house price inflation does not accelerate and undermine the ability to keep inflation on target.

Work is already underway on the new Island Plan which will be critical in determining the supply of housing in the future.

Action 9: The Economic Adviser in 2008 to review the interaction of all States housing policy to determine its impact on housing demand and suggest areas for reform (if required) that will better enable housing demand to be more in line with supply in the future.

3. Communicating policy

A key element of successful anti-inflation policy is effective communication. Policy must be credible, transparent and widely understood if it is to achieve its aims. Another key component of the new strategy is to raise awareness and understanding of what causes inflation in Jersey and what the consequences are for the Island of failing to keep inflation under control.

The more widely understood the implications of inflation are and the policies that are in place to control it, the increased possibility of success. Everybody has a role to play in terms of keeping inflation in check – employers, employees and the States. All parties need to understand what causes inflation and their role in keeping it under control.

If action is taken in all the areas outlined above and the work that is already underway properly addresses the issues raised, then Jersey will have the right policies in place to keep inflation on target in the future. If action is not taken, the Island could easily be exposed to a change in the inflationary winds that stems from outside the Island. As Kenneth Rogoff said when he was IMF Economic Counsellor in December 2003 if the favourable winds do change then –

“Those countries that have taken advantage of the present benign inflation environment to strengthen their institutions will be well placed to ride out the storm. Countries that have done no more than let the winds of globalization bring down their inflation rates may be seriously vulnerable to reverse.”

A NEW ANTI-INFLATION STRATEGY FOR JERSEY

1. Understanding inflation

What is inflation?

Inflation, put simply, is a general rise in prices across the economy. The inflation rate is a measure of the average change in prices across the economy over a specified period (12 months in the case of the annual rate of inflation).

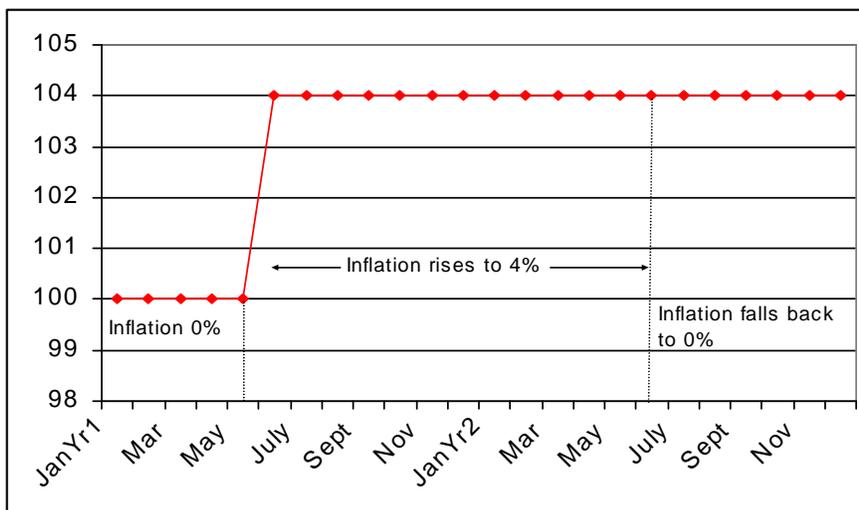
To get an understanding of what the current rate of inflation is, it is necessary to measure the change in prices across the economy. This is normally done by constructing an index of prices and measuring its percentage change over time. The most commonly used index is a Retail Prices Index (RPI) which is made up of the weighted prices of hundreds of goods and services in retail outlets such as supermarkets, petrol stations, travel agents and insurance companies.

A rise in the price of any particular good or service can influence the rate of inflation, if it is large and/or the good/service has a significant weight in the index. For example, suppose the price of petrol has a weight of 20% in the RPI (far larger than is the case) and it rises by 20% in a particular month. If all other prices remain unchanged this would lead to a 4% rise in the index and inflation in that month. However, if all prices in the index stay unchanged, in the same month of the subsequent year the impact falls out of the annual comparison.

This example is illustrated in the chart below –

Chart 3: The impact of a one-off price increase on the RPI index and inflation

RPI index where January Year 1 =100 and petrol prices make up 20% of RPI index and rise by 20% in June of Year 1, with other prices constant



Source: Economics Unit

A one-off increase in the price of goods such as the example outlined above can clearly impact on the inflation rate but is not considered to be a rise in the general level of inflationary pressure in the economy. The fact that the impact falls out of the annual comparison shows that the impact is only short-term, unless it generates any second-round effects (discussed in more detail below).

How inflationary pressure affects the rate of inflation

The real inflationary danger in an economy is not then from a one-off price increase, but from a situation where there is a build-up of inflationary pressure in the economy. Inflationary pressure occurs when the overall level of demand for goods and services exceeds the ability of the economy to supply them (putting upward pressure on

prices).

This might occur if incomes (personal and/or government) rise across the economy due to a windfall to the government. For instance, if oil was discovered in Bailiwick waters, the States of Jersey might be able to reduce taxes and increase expenditure. However, if there is no extra capacity in the economy to meet the extra demand for goods and services (both from the government and consumers with additional spending power) then inflationary pressure will be created and the general rise in prices that comes with it.

Expectations can also have a crucial impact on the inflation rate and inflationary pressure. If businesses and employees expect inflation to rise over the coming months they are likely to factor this into the prices they charge and the wages they demand. If this results in even higher prices, then an upwards spiral effect can be created. Central bankers across the globe have been successful at reducing inflation because of their ability to reduce inflation expectations across the economy by adopting inflation targets.

In the example cited above looking at the impact of a one-off increase in the price of oil, there could be 2 important second-round effects that could mean the initial one-off rise in the price level has a lasting impact on inflation –

- Firstly, oil is an important input into many business activities and a sustained increase in the oil price could actually reduce the supply capacity of the economy. If demand is unaffected (or affected to a lesser degree) then the balance between supply and demand could be altered and inflationary pressure could increase as a result.
- Secondly, there could be second-round effects where businesses and/or people respond to the initial increase by increasing prices and/or wages and that cost-push inflationary pressure could result.

The costs of inflation

Having considered what inflation is and how it is measured, the obvious question is why is so much emphasis placed on controlling it? The best way to see how damaging inflation can be is to contrast it with a situation of price stability.

Price stability enables money to work as the means by which people and businesses transact and contract with one another. The main problem with inflation is that people and firms change their behaviour as they attempt to avoid the uncertainty associated with rising inflation. Price stability helps create an environment where economic growth may occur more easily. Inflation, on the other hand, results in the country's economic resources being used less effectively and efficiently than they could be. Economic growth suffers as a result.

Another way in which inflation impacts on the economy is by clouding relative price signals. When inflation is high, for instance, it can be volatile. It therefore becomes less clear whether an increase or decrease in the price of goods or a service reflects a change in the relative demand or supply, or whether it is just part of a generalised movement in prices across the board. On the other hand, if prices are stable, people and companies are able to make their investment, saving and purchase decisions more accurately without distorting signals. There is also the possibility that inflation will have an inequitable impact – hitting those people that save for retirement harder than those that simply spend their money on goods.

Many years of experience across different economies have shown that one of the main consequences of high inflation has been greater instability in economic conditions. Periods when demand has been growing more rapidly than output and inflation has risen have been followed by periods when demand and output (and employment) have fallen sharply (the boom and bust cycle). These falls were probably greater than would have been the case had demand and output grown at a steadier and more balanced pace.

What does this mean for Jersey?

Putting this in a Jersey perspective, higher inflation would have damaging implications for the Island because it will –

- undermine economic efficiency and make it harder for the Island to achieve sustainable economic growth;
- reduce the competitiveness of the Island's many export industries such as finance, tourism, agriculture and fulfilment;
- make Jersey a less attractive place in which to do business and live.

Understanding aggregate demand and supply

If inflationary pressure in an economy is due to the overall level of (aggregate) demand exceeding the overall level of (aggregate) supply then it is important to understand fully what determines aggregate demand and supply in an economy.

What is aggregate demand?

Aggregate demand (**AD**) is the total demand for goods and services produced in the economy over a period of time. It is made up of 4 parts –

- Consumption (**C**) expenditure: demand by individuals
- Business domestic investment (**I**) expenditure: demand by businesses
- Government (**G**) expenditure: demand by government
- Net exports (**X-M**): demand by the rest of the world for an economy's output

Therefore the level of aggregate demand in an economy is given by:

$$AD = C + I + G + (X-M)$$

Factors that affect aggregate demand

Factors that determine each of the four components above will affect aggregate demand.

- **Consumption expenditure:** will be influenced by consumers' income/wealth, consumer expectations about future income/wealth, taxes on consumers, etc.
- **Investment expenditure:** will be affected by interest rates, profit or rate of return expectations, taxes on businesses, etc.
- **Government expenditure:** will be influenced by political objectives, new policies/investment programmes, the cost of new/current programmes, predicted future tax revenues, etc.
- **Net exports:** will be affected by international competitiveness, export and import demand, etc.

What is aggregate supply?

Aggregate supply is the total amount of goods and services that can be produced in the economy at a given price level. In the long run, aggregate supply is determined by the amount of resources available (labour, land and capital) and the productivity of them.

Factors that affect aggregate supply

Aggregate supply basically reflects the productive capacity of the economy and the costs of production in each sector. An increase in aggregate supply can be caused by the following:

- Increase in the size and/or productivity of the labour force
- Increase in the amount and/or productivity of capital stock through investment
- Improvements in technology and innovation
- Decrease in the cost of labour
- A fall in producer taxes or an increase in subsidies
- Lower inflation expectations (likely to temper wage increases)

Types of inflation

Having considered that inflationary pressure is caused by aggregate demand exceeding aggregate supply and the factors that affect them, it is easier to understand the main causes of inflation. There are 2 basic causes of inflation:

1. **Demand pull inflation:** is when aggregate demand increases in the economy (due to any of the factors outlined above) to the extent that it exceeds supply in the economy.
2. **Cost push inflation:** is when the supply base in the economy contracts relative to the level of demand (leading to excess demand in the economy) and can be caused by factors that reduce aggregate supply such as higher raw material prices or wage rates.

2. Inflation in the global economy

Over the course of the last 15 years there has been considerable success in reducing inflation across the globe. The chart below shows that, on average, world inflation has fallen from close to 35% in 1992 to below 4% in the early 2000s. In the advanced economies there has been success in reducing inflation from 12% in 1980 to 5% in 1990 and to about 2% in the early 2000s.

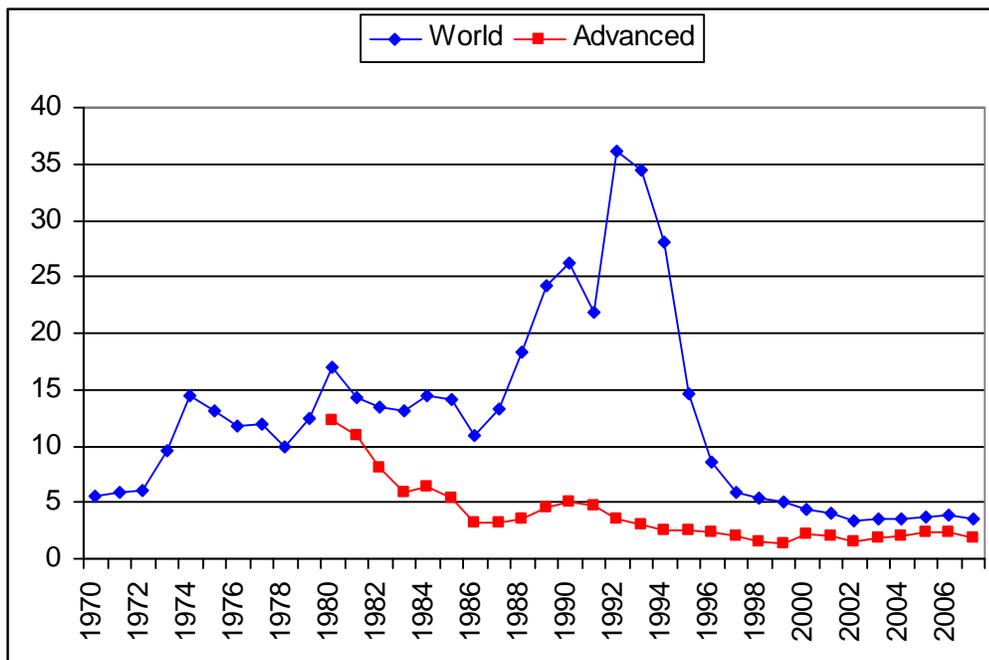
There have been a number of important factors at play in achieving this success. Namely –

1. Better policy-making through central bank independence and inflation targeting
2. Globalisation and the increased competition it brings
3. Better management of fiscal policy
4. Improved productivity (at least in some countries).

It is conceivable that this benign global inflation outlook could be disturbed if any of these factors went into reverse and that inflation could flare up again. Although developments over the last 10 years have been encouraging there is no room for complacency.

Chart 4: World inflation

% change in consumer price indices



Source: IMF

Inflation targeting

As already discussed, one of the factors underpinning the success across the globe in reducing inflation has been improved monetary policy and in particular success through inflation targeting. Since New Zealand pioneered inflation targeting in 1989 many countries across the world have followed suit and made it a cornerstone of monetary and anti-inflation strategy.

Although Jersey does not have its own monetary policy (because it is in a monetary union with the UK) an inflation target is still an important part of anti-inflation policy. This is because it acts as an anchor to which people can refer and provided that it is backed by credible policies will also help to keep expectations about inflation in check. Without an explicit inflation target, people and businesses are less aware of what policy is trying to achieve and this may even mean that anti-inflation policy is less effective.

The intention is not to meet the target at all times but the aim is to keep inflation close to target over the medium-term. Economies with control over their own interest rates do not attempt to meet the target at all times, not least because this could prove damaging to do so. It is also recognised that inflation significantly below target is as much of a concern as inflation significantly above target. If inflation moves significantly above or below target the first concern is what has caused the trend and importantly will it be sustained over the medium-term. Only then can it be determined if there is need for a policy response and what if any is the most suitable option.

The previous anti-inflation strategy agreed by the States in 2000 adopted an inflation target of 2.5% for RPIX (retail prices index excluding mortgage interest payments). This target of 2.5% is consistent with an approach that focuses on price stability, the ultimate aim of inflation policy. The fact that it has been the target for the last 7 years also means that policy will benefit from consistency from continuing with the same target.

RPIX is also the right index of retail prices to target in general because it excludes the impact of interest rates which can create distortions in the measure of inflation. For example, in the short-term, higher interest rates push up RPI and this could be interpreted as higher inflation but in reality the higher rates will act to keep inflation under control and help meet the inflation target.

The UK moved from targeting RPIX to a new index, the Harmonised Index of Consumer Prices (CPI) in December 2003. The basic approach to the measurement of inflation adopted by both RPIX and CPI is the same – they track the changing cost of a fixed basket of goods and services over time. However, there are a number of differences in the way the indices are constructed which fall into 3 categories–

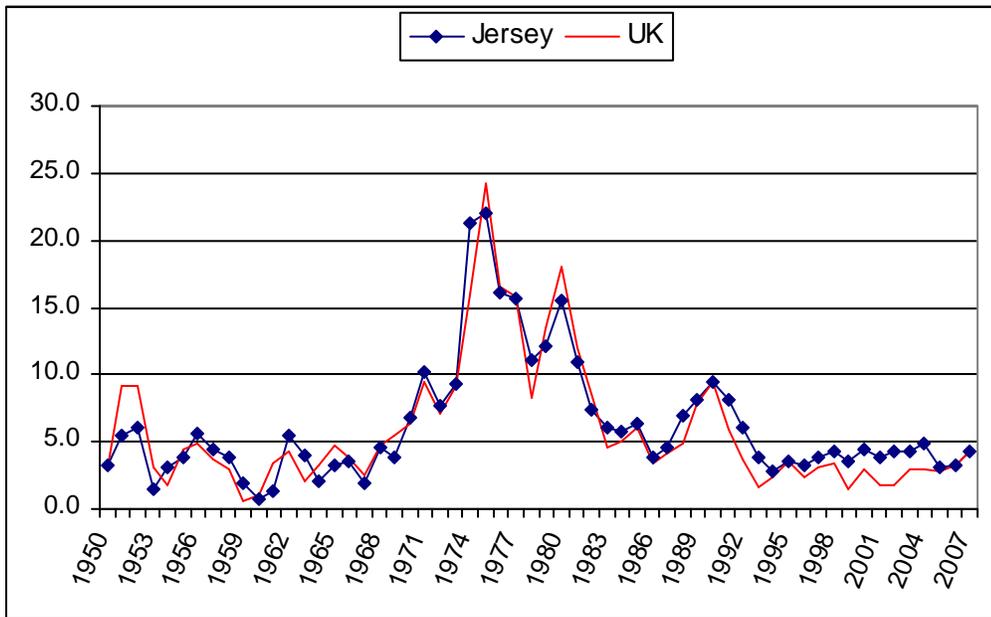
- the consumers or households covered by the index
- the range of goods and services that are included (most notably CPI excludes housing costs)
- the way the prices are measured and combined (i.e. the method of weighting).

On average RPIX in the UK has exceeded CPI by 0.7% between 1989 and 2007. This suggests that there could be some potential benefits from moving to CPI in Jersey. However, with a host of new inflation measures just introduced (RPIY, RPI low income and RPI pensioners), further consideration should be given to the potential benefits, the differences between the 2 measures, costs in terms of resources required to produce another index and risks to transparency from changing index and target.

3. Inflation in Jersey and the UK

Having considered what inflation is, the problems it can cause and trends in inflation across the Globe, it is worth now looking specifically at inflation in Jersey. The chart below considers past trends in inflation in Jersey and the UK as measured by the RPI. The UK is a useful comparison because Jersey has significant trade links with the mainland and Jersey is part of a currency union with the UK. Many of our products are sourced from the mainland and the UK is also an important export market for the Island. The fact that the UK is a large successful economy with control over interest rates may mean it is a high benchmark for comparison, but at the same time it is an important comparison to make as the Jersey economy will be sensitive to differences in inflation with the UK.

Chart 5: Jersey and UK inflation compared % change in RPI



Source: States of Jersey Statistics Unit/National Statistics

The chart shows that over the whole period 1949–2007 Jersey inflation has tended to move with that in the UK and averaged 6.2% compared to 5.8% in the UK. However, there do seem to be 3 distinct periods within that timescale. Firstly, in the 1949–1990 period inflation in Jersey and the UK moved closely together and both averaged 7%. Secondly, between 1990 and 2004, Jersey inflation exceeded that in the UK – averaging 4.4% compared to 2.9%. Thirdly, between 2005 and 2007 when inflation in both the UK and Jersey moved closer again and averaged 3.5% in Jersey and 3.4% in the UK.

The post-1990 period is the one where the UK has had the most success in reducing inflation due to a combination of factors that built on previous improvements in the flexibility of labour and product markets –

- the initial membership of the ERM
- the subsequent development of a more credible, transparent and effective monetary policy regime culminating in the independence of the Bank of England
- the increasing impact of globalisation
- tighter control of government finances.

Jersey seems to have missed out on these benefits to such an extent that inflation averaged over 1.0% more than in the UK over the 1990–2004 period, although in the period since then Jersey has seen inflation fall back to UK levels. There was even a period between 2005 (3rd Quarter) and 2007 (3rd Quarter) when inflation in Jersey was at or below that in the UK. This begs the question as to why Jersey inflation moved closely with that in the UK for many years and then during a period of sustained low inflation in the UK the correlation was broken? Also, what has changed in recent years to allow Jersey inflation to fall back to UK levels?

The previous analysis of the causes of inflation suggests that the explanation must lie in a change in the balance of supply and demand in the UK between 1990–2004 which was not reflected in Jersey, or indeed a worsening in the balance between supply and demand in Jersey that the UK did not experience. More recently, the balance in Jersey must have improved or been more in line with that in the UK.

It is worth looking at the factors that could have contributed to the fall in inflation in the UK (on both the demand and supply side) and see to what extent they have been reflected in Jersey. There are a number of explanations that are commonly put forward as reasons for the UK's success in achieving sustained low inflation that are worth considering to see if they have been replicated in Jersey –

- Reduced volatility in the UK economy and an improved balance between demand and supply. By contrast, has Jersey been more volatile than the UK and therefore seen greater imbalance between supply and demand?
- The improved monetary policy framework in the UK has had success in reducing inflation, allowing interest rates to remain low to support growth. This could also mean that interest rates set in the UK have been targeted clearly at the UK economic situation and not at that in Jersey meaning they have been more effective at reducing UK inflation.
- Another explanation often put forward is that there has been improved management of the public finances in the UK and this has contributed to a more stable economic climate and helped to reduce inflation. Is this true and if so, have such trends occurred in Jersey?
- The impact of globalisation has fed through into lower prices for certain goods in the UK. Have such trends been repeated in Jersey? Or is there evidence that in Jersey prices are sticky and have not fallen to the same extent as in the UK?
- Supply side improvements and flexible markets have kept costs down in the UK (increasing the supply capacity in the economy). By contrast, have cost increases in Jersey continued at a greater rate than in the UK meaning inflation has been unable to fall to the same extent in Jersey?
- Trends in the housing market can also impact on the economy and inflation. Rising house prices can add to demand in the economy through wealth effects (people feel better off and are prepared to consume more as a result). But rising house prices can also impact on the supply side through the costs of living and labour mobility. Have trends been different in the UK and Jersey?

Each of these potential explanations is considered in the following sections under –

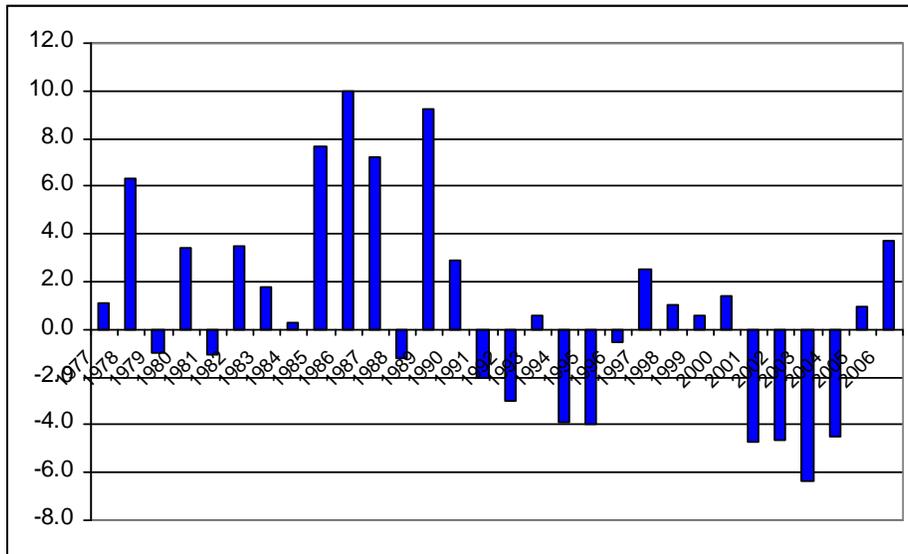
- 3.1 Economic cycles**
- 3.2 Balance of policy**
- 3.3 UK goods deflation**
- 3.4 Costs adjustment**
- 3.5 Supply side**
- 3.6 House prices**

3.1 Economic cycles

The chart below looks at the difference in the overall economic performance in terms of the change in real GVA. The first thing to note is that the overall performance of the UK and Jersey economies are not closely correlated. There are very few times when growth seems to be at a similar level to that in the UK and in fact the Jersey economy seems to swing from periods of outperforming the UK to periods when it underperforms.

Chart 6: Growth differentials between Jersey and the UK

% change in Jersey real GVA minus % change in UK



Source: States of Jersey Statistics Unit/National Statistics

There does appear to be a number of different phases over the period covered by the chart. Firstly, the period 1977–1990 when on average Jersey growth tended to exceed that of the UK and by about 3.6%, but whilst inflation remained broadly in line between the 2 jurisdictions. Secondly, a period when Jersey growth seemed to be more volatile relative to the UK (and went from periods of being below UK growth to ones where it was above it). Over this second period, Jersey inflation averaged 4.2% compared with 3.0% in the UK. There would appear to be some evidence that the greater volatility of the Jersey economy over this period has coincided with higher inflation in Jersey.

Looking purely at differences in economic growth rates is not necessarily looking at the full picture. The previous analysis of inflationary pressure and aggregate demand and supply tells us that the valid comparison is not of pure growth rates but the rate of growth relative to the degree of spare capacity in the economy. For example, 7% economic growth could be less likely to lead to higher inflation at a time when there is plenty of spare capacity in the economy than 3% at a time when the economy is at a or above capacity. The real question is whether Jersey has experienced longer periods of aggregate demand being above aggregate supply? If so, that could at least partly explain why inflation in Jersey has been above that in the UK over the period.

To make such a comparison it is necessary to consider the extent of the output gap in each economy. That is, the extent to which actual output (measured by GVA or GDP) has been above or below the potential (capacity) of the economy. Data for the UK is produced by the IMF and many other sources. Getting comparable data for Jersey is harder.

To estimate the output gap ideally you need a long run of reliable data covering trends in GVA, inflation and employment. From this you can assess the trend rate of growth in the economy (the degree to which potential output will grow) by looking at the long-term average rate of growth. You can also consider when the economy is likely to have been at full capacity by looking at periods when employment and inflation are close to the long-run average. By combining the two it is possible to estimate when the economy was operating above and below its capacity and when there was likely to have been a build-up of inflationary pressure.

Estimating the output gap in Jersey is complicated by 2 factors. Firstly, the long-run of data covers the period in the 1980s when the economy was able to grow very strongly without accelerating inflation largely because capacity was able to expand through increased land use and population growth (the long-run data is also less reliable as the pre-1998 data is broad estimates only). Both land and labour are much more binding today than they were during this period and this would suggest that the trend rate of growth is below what it was then.

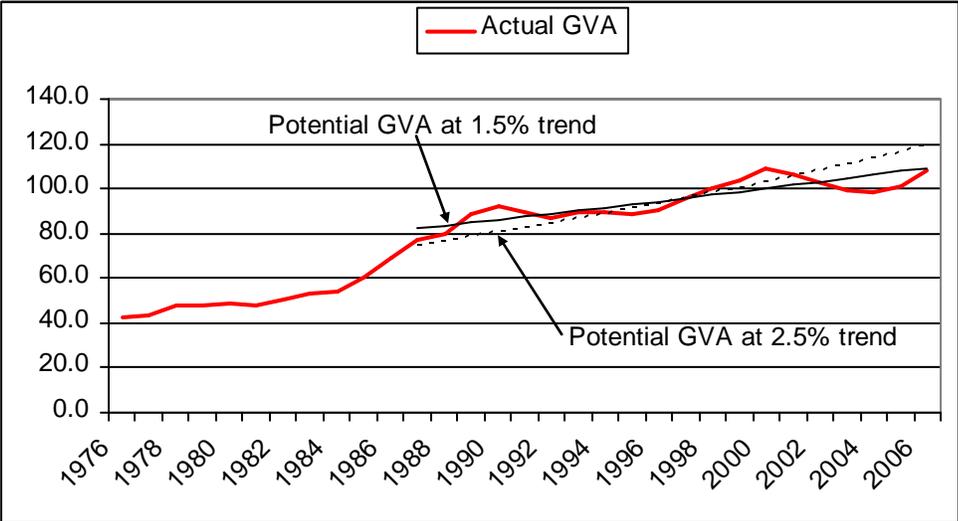
Secondly, data for variables such as employment only go back until 1996 which makes assessing when the economy is at capacity that much harder. However, one thing that is clear is that the economy peaked in 2000 and

that would suggest that at that point it was operating above capacity and that the phase of the cycle before that year must have involved the economy moving from significant spare capacity, through operating at capacity up to the peak. In the period after that year the economy must have moved from above capacity, through operating at capacity to operating below capacity. That is, the economy must have been at capacity at some point between 1996 and 1999 and similarly at some point between 2001 and 2005.

Looking at employment trends over the recent cycle it is clear that employment peaked in 1998 and that would suggest that the economy was probably operating above capacity at this stage. That would tend to point to 1997 as a year when the economy was operating close to capacity.

The chart below looks at the trend in Jersey GVA relative to potential GVA at trend growth rates of 2.5% and 1.5%. The 2 trend rates of growth are used to allow for some sensitivity given the large margin for error likely to be involved in such calculations of GVA relative to potential. Rather than being precise estimates of the degree of spare capacity in any one year (that is a detailed piece of research in itself) they are more illustrations of the likely different phases of the economic cycle. For example, both calculations assume that the economy was at capacity in 1997, that it then moved above capacity in the late 1990s and early 2000s, before then moving below capacity again. Either comparison shows that there was likely to be spare capacity in the economy in 2006 but clearly much less if trend growth is closer to 1.5% than 2.5%.

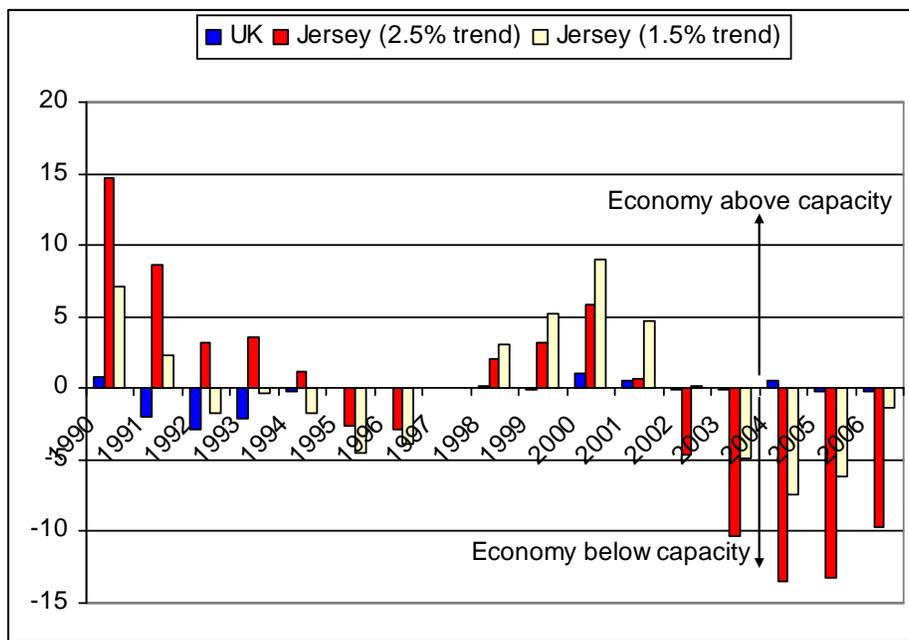
Chart 7: Assessing the output gap in Jersey
 Jersey real GVA 1998 = 100, potential GVA at 1.5% and 2.5% trend rates



Source: States of Jersey Statistics Unit/Economics Unit calculations

To see whether these trends can help explain why inflation in Jersey persisted above that in the UK for so long during the post-1990s period it is necessary to look at what happened to the UK output gap over that period as well, which is shown in the chart below. It shows that the Jersey economy has been much more volatile than that in the UK, moving from periods of spare capacity to above capacity while the UK has seen much more stable economic growth relative to its supply capability. The uncertainty about the degree of spare capacity in the Jersey economy means it is not possible to say with certainty whether Jersey has operated on average with more or less spare capacity over the period than the UK.

Chart 8: The output gap in Jersey and the UK
 Deviation of actual GVA from potential as % of potential GVA



Source: Statistics Unit/Economics Unit calculations/IMF

What is apparent is that the Jersey economy went through a significant downturn in 2001–2004 and at a time when the UK was experiencing sustained economic growth and low inflation. This extended period when the economy was below capacity could partly explain why Jersey inflation has become more in line with that in the UK in recent years. That is, the capacity pressures in Jersey eased significantly and at a time when the UK continued to expand when it was close to capacity.

Consideration of the difference in economic cycles in Jersey and the UK and particularly of the output gaps does provide, at least in part, some explanation as to why Jersey and the UK experienced different inflation trends over the course of the period.

One thing that is quite striking about this comparison is the volatility in the Jersey economy relative to that in the UK. The UK has seen sustained economic growth since 1992 while Jersey has actually seen quite volatile trends and significant swings between being above capacity to below capacity. This in itself could also be an explanatory factor as to why higher inflation has persisted in Jersey.

Greater volatility can lead to increased uncertainty and this could have influenced expectations about inflation. The lack of sustained economic growth and the more volatile cycle in Jersey could have meant that people and businesses did not believe that inflation would stay low in Jersey and that their expectations (reflected in prices and wages) never adjusted downwards, which appears to have happened in the UK as low inflation has been sustained. The more volatile cycle in Jersey could therefore have led to rigidities in the Jersey economy and that do not exist (any longer) in the UK.

The chart does suggest that there may be some evidence that the Jersey economy exhibits greater rigidity than the UK. Periods of strong economic growth such as those in the late 1980s and late 1990s do push up inflation (and above that in the UK) but when growth weakens, prices continue to rise at previous rates and inflation persists at previous rates during the slowdown. Only after several years of weakness does the economy start to adjust and inflation then falls back (more in line with that in the UK). This could be caused by rigidities whereby the economy does not adjust to lower inflation (or takes a long period to do so) because people and businesses do not adjust their wage demands and pricing policies and costs and prices continue to rise as they did in the good years.

3.2 The balance of policy

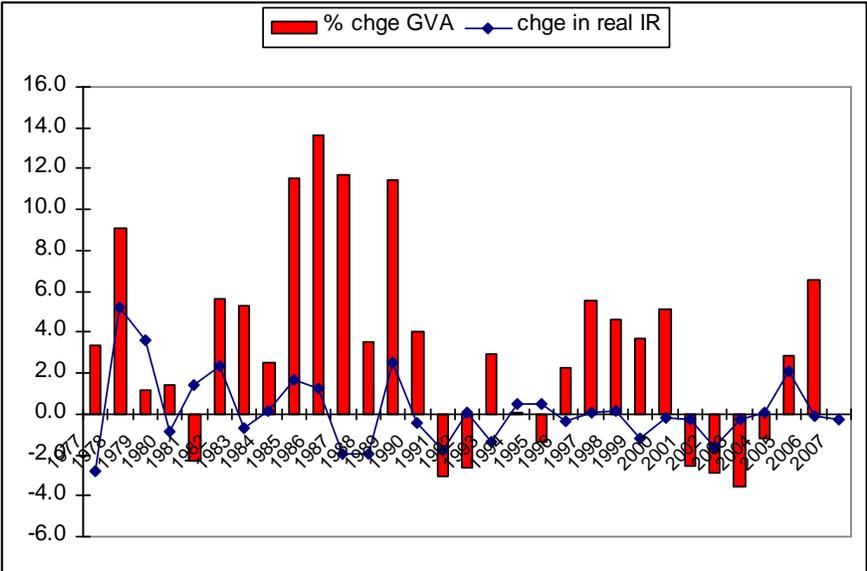
Real interest rates

One consequence of being in a monetary union with the UK is that interest rates are set by the UK authorities in respect of current and expected future economic conditions there, and the requirement to meet the UK's inflation target. The economic conditions will often not be the same as those faced in Jersey (as Chart 8 above clearly shows with a wide divergence in growth trends) and the result could be that interest rates are not appropriate for Jersey economic conditions. This can result in increased volatility in the Jersey economy and/or higher inflation.

The chart below considers growth trends in the Jersey economy and changes in real interest rates. It can be seen that on some occasions when the economy has been growing strongly real interest rates have risen, and at other times when the economy has declined real interest rates have fallen. However, this is by no means the case at all times and there are numerous cases when real interest rates have fallen when the economy is growing strongly or when they have increased when the economy is still weak.

What is noticeable is that in the post-1990 period when Jersey inflation has persistently stayed above that in the UK, real interest rates have been relatively stable. Lower inflation in the UK has tended to allow interest rates to come down and stay down, but because inflation has stayed generally higher in Jersey real interest rates have been significantly lower than in the UK. Between 1975 and 2007 real interest rates averaged 1.6% in Jersey and 2.3% in the UK. More recently though, between 1990 and 2007, they averaged 1.8% in Jersey and 3.0% in the UK.

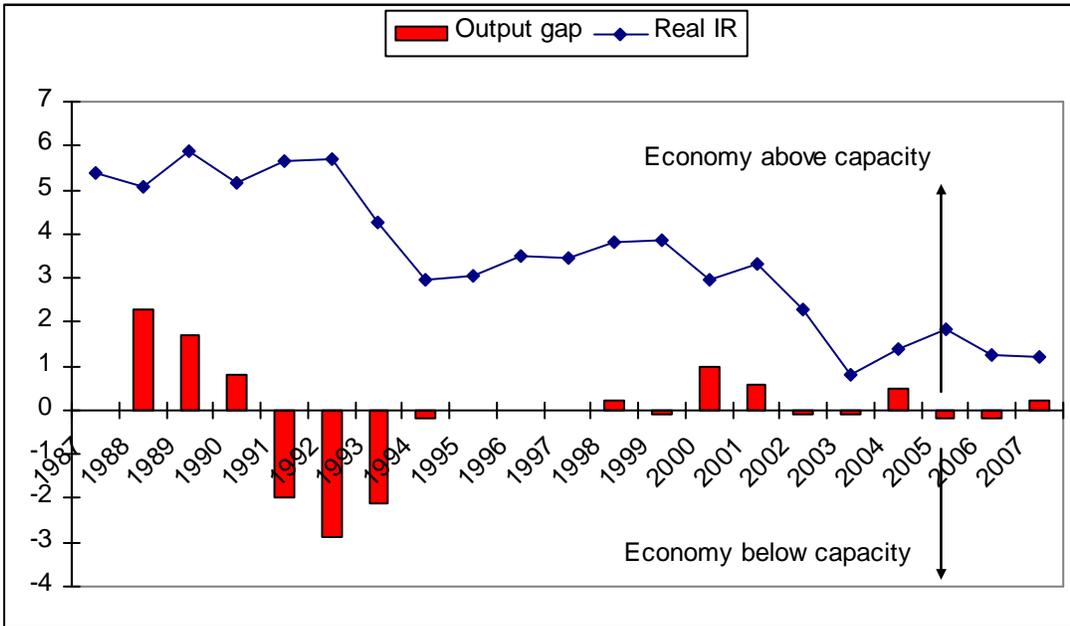
Chart 9: Economic growth and real interest rates in Jersey
 % change in real GVA and change in real interest rate (base rate less RPI)



Source: States of Jersey Statistics Unit/National Statistics/Economics Unit calculations

This analysis so far does not take into account at what stage in the economic cycle the growth is taking place. For example, higher real interest rates may not be necessary even if the economy is growing strongly when there is significant spare capacity in the economy. The chart below looks at real interest rates and the degree of spare capacity in the UK economy.

Chart 10: The output gap and real interest rates in the UK
 Deviation of actual GVA from potential as % of potential GVA and real interest rate

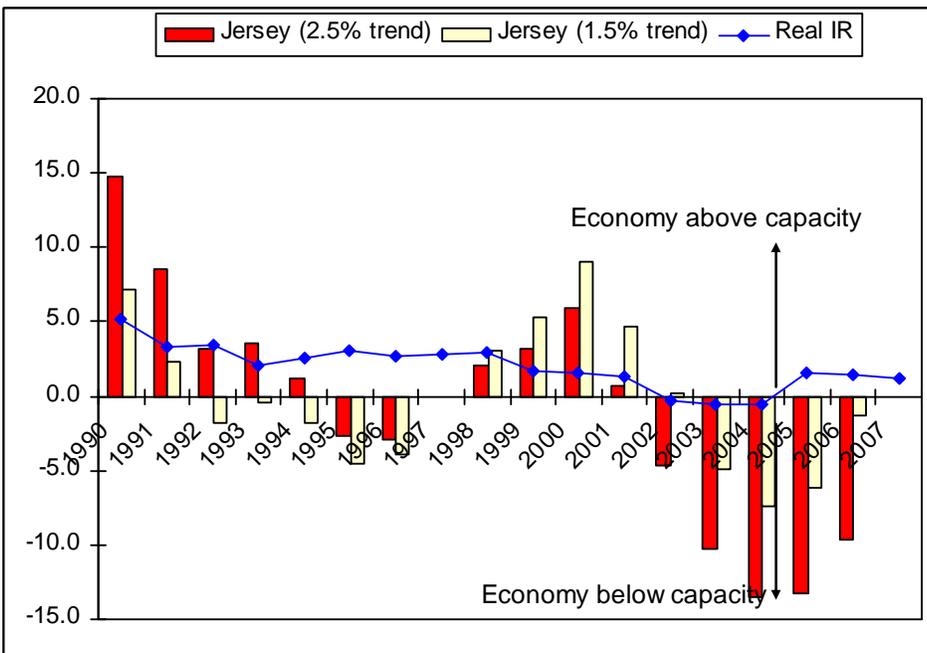


Source: National Statistics/IMF/Economics Unit calculations

It is clear from the chart above that as UK economic performance has been stable, real interest rates have fallen, allowing economic growth to continue while inflation has been kept in check. Also at times when the economy has been below capacity (e.g. early 1990s) real interest rates have fallen. When the economy has been above capacity real interest rates have increased (e.g. 2002 and 2004). The next chart considers what the trends have been in Jersey.

Chart 11: The output gap and real interest rates in Jersey

Deviation of actual GVA from potential as % of potential GVA and real interest rate



Source: States of Jersey Statistics Unit/National Statistics/Economics Unit calculations/IMF

For interest rates to be working with the Jersey economic cycle you would expect to see real rates rise when the economy is above capacity and fall when it is below capacity. In fact the chart shows that –

- in the early 1990s the economy was above capacity but real interest rates fell;
- in the mid-1990s the economy was below capacity but real interest rates remained fairly static;
- in the late 1990s the economy was above capacity but real interest rates did not rise and actually fell slightly in some years;
- in the early 2000s the economy was below capacity and real interest rates did fall and turn negative;
- in the period since 2005 when the economy has grown strongly, real interest rates rose but then fall back again as spare capacity in the economy has been eroded.

This analysis shows that real interest rates have not been in line with the need of the Jersey economy during many recent periods of the economic cycle. This is not surprising given that changes in real rates are determined by a combination of changes in Jersey inflation and UK interest rates (which are now set by the Bank of England to meet the UK inflation target). Unless other policies (in particular fiscal) have acted to counteract this affect then the trends in real interest rates will have only served to have added to volatility in the Jersey economy rather than smooth it out and could therefore have contributed to the better inflation performance in the UK in the 1990s.

The required tightening of real rates that was required in the late 1990s in Jersey for an economy that was growing strongly and had inflation above target did not occur, and this could have contributed to higher inflation in Jersey persisting well into the early 2000s and only coming down to target in recent years (when real interest rates were not reduced significantly despite the weak performance of the Jersey economy). Lower real interest rates than is appropriate for the Jersey economy in times of strong growth and little spare capacity will only help to reinforce the trend of inflation in Jersey being above that in the UK. In turn, this will make it less likely that UK interest rates are going to be right for keeping inflation in check in Jersey.

Public finance trends

It is also worth considering what was happening to public finances in the UK and Jersey over the course of the 1990s to see if that might have had any bearing on inflation in the 2 jurisdictions. Did public finance trends work to offset the impact of real interest rates when they were not right for Jersey or did they serve to exacerbate the situation?

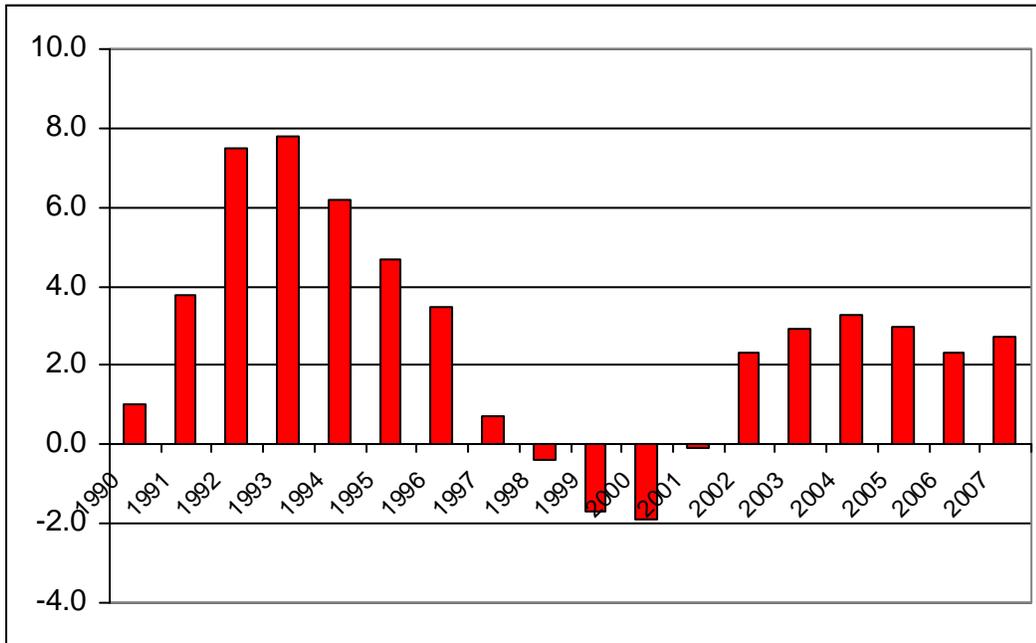
At first glance it might appear that public finances can provide little of the explanation. The UK was borrowing significant sums of money each year to fund government expenditure, while Jersey in general terms tended to balance its books. Such a cursory glance does not give a true reflection of the picture.

The analysis in section 1 shows that government spending contributes to aggregate demand in the economy. The extent to which it is financed by borrowing rather than taxes (which tend to reduce other elements of aggregate demand) generally gives an indication of the additional momentum that government activity is giving to the economy.

In Jersey the situation is slightly different. Taxation revenue is largely determined by the performance of the financial services sector and critically is drawn from outside the Island. Few economies have such a large source of revenue which is largely drawn from external sources (and does not need to be repaid). In the Jersey case, government revenue rises the better the financial services industry performs, but without taking funds from within the economy (so the other components of aggregate demand are not affected). At the same time the strong performance of the financial services industry will mean that the economy has less spare capacity (due to the links to sectors such as retail and hotels/restaurants/bars).

In the UK in the 1990s successive governments made commitments to bring borrowing down and constrain government expenditure growth. The chart below shows that this was successful throughout the 1990s and that this will have meant that the UK moved from a position of adding significant stimulus to the economy in the early mid-1990s to being in a position by the late 1990s where the government was actually dampening the economy.

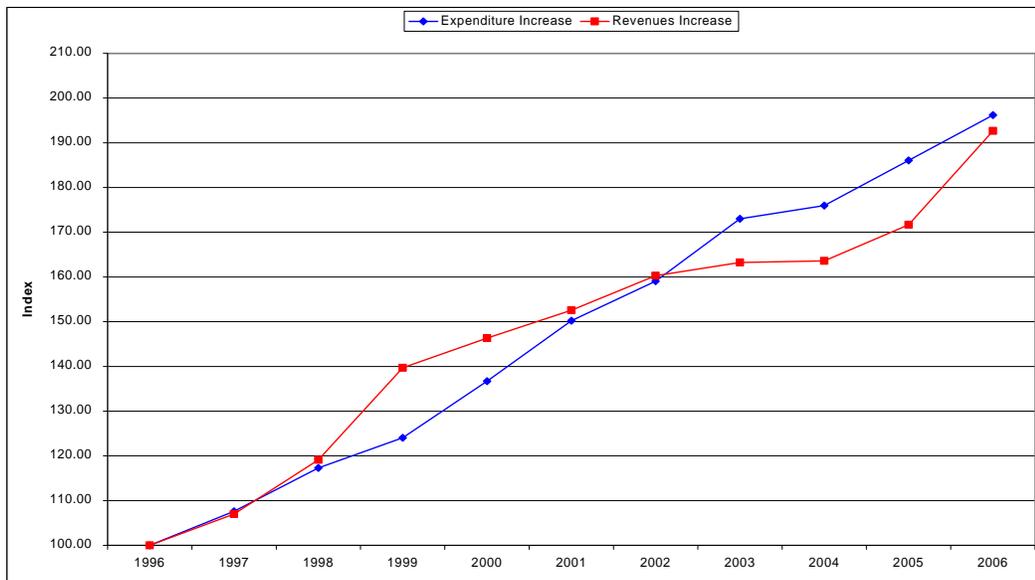
Chart 12: UK government borrowing
Net borrowing as % GDP



Source: UK Treasury

It is interesting to note how this compares to the situation in Jersey. In the 1990s Jersey was broadly balancing the books although this did mean that strong growth in revenue in the late 1990s allowed for strong growth in expenditure at a time when the economy was growing strongly and more than likely operating above capacity. A large part of the revenue growth will have originated from outside the Island (finance taxation) and there was a real risk that such expenditure growth will have fed straight into aggregate demand and inflationary pressure.

Chart 13: Jersey income and expenditure
Index, 1996 = 100

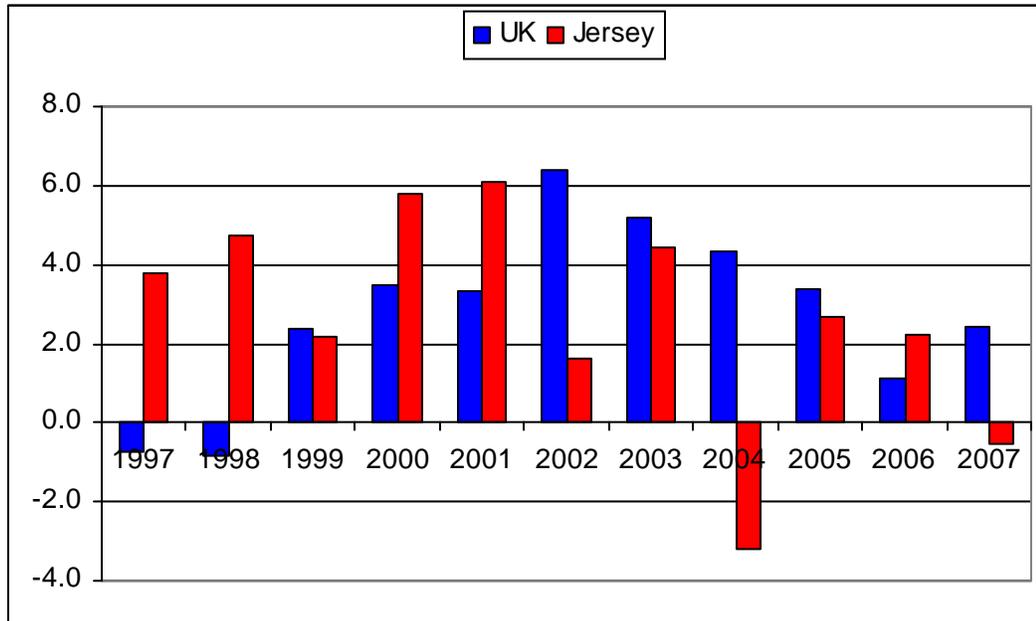


Source: Treasury and Resources

The end result of these two different trends in public finances is shown in the chart below. Government current spending in Jersey was able to grow strongly in real terms in the late 1990s/early 2000s and in many years in

excess of that in the UK. This was at a time when the Jersey economy was operating above capacity (and the UK much more in line with capacity) the end result of which would have been to add to inflationary pressure in the Jersey economy. It is noticeable that from 2001 the situation has been reversed with real Jersey government spending growing at a slower rate than that in the UK.

Chart 14: Jersey and UK government spending
Real % change in UK and Jersey current expenditure



Source: Treasury and Resources/UK Treasury

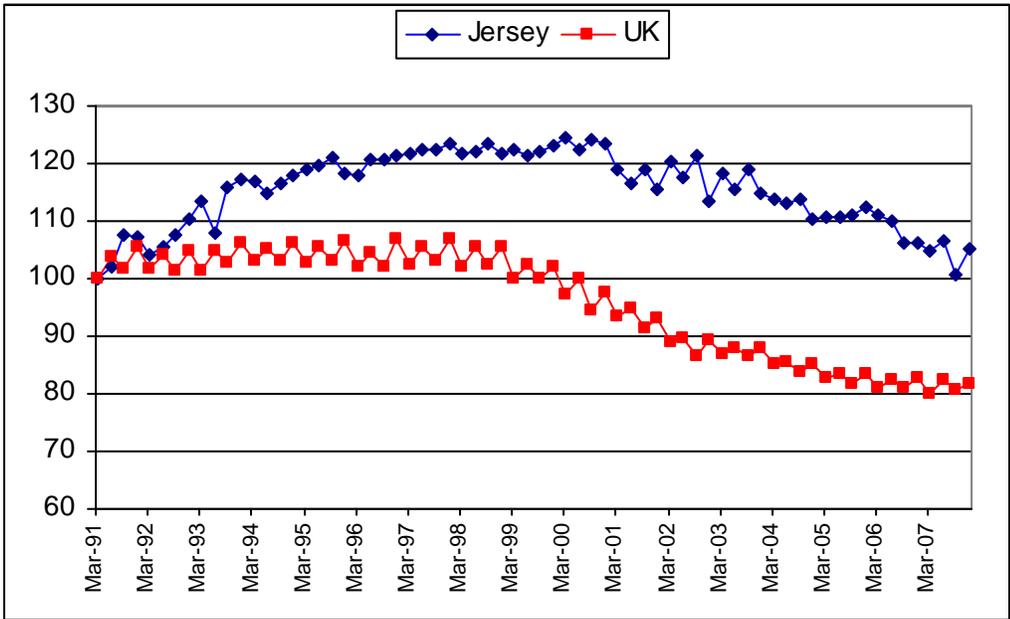
3.3 Goods deflation

One of the underpinning factors of the UK's success in reducing inflation has been the impact of increased competition – through globalisation and in the domestic market – and the introduction and use of new technology which has meant that prices of some goods have actually fallen for a sustained period while others have only increased very slightly. These trends in goods prices have helped to offset higher rates of price increase for some services.

Two areas where price reductions have been prominent are in the clothing/footwear sector and in leisure goods (audio-visual equipment, CDs, photographic equipment, etc.). The prices of food and household goods in the UK have also exhibited below-average increases over the period between 1991–2007.

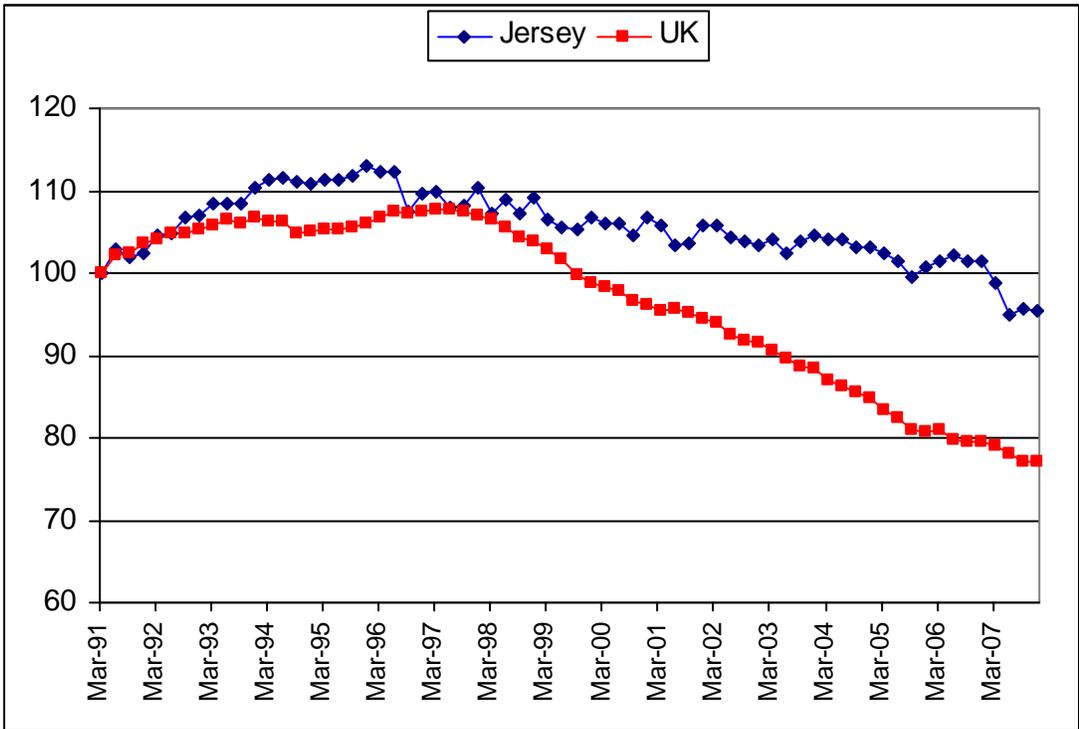
A valid question is how have the prices of these goods changed in Jersey over the same period? The charts below compare the trends between the UK and Jersey in each case.

Chart 15: Clothing and footwear prices in the UK and Jersey
Index of prices, 1991 (1st Quarter) = 100



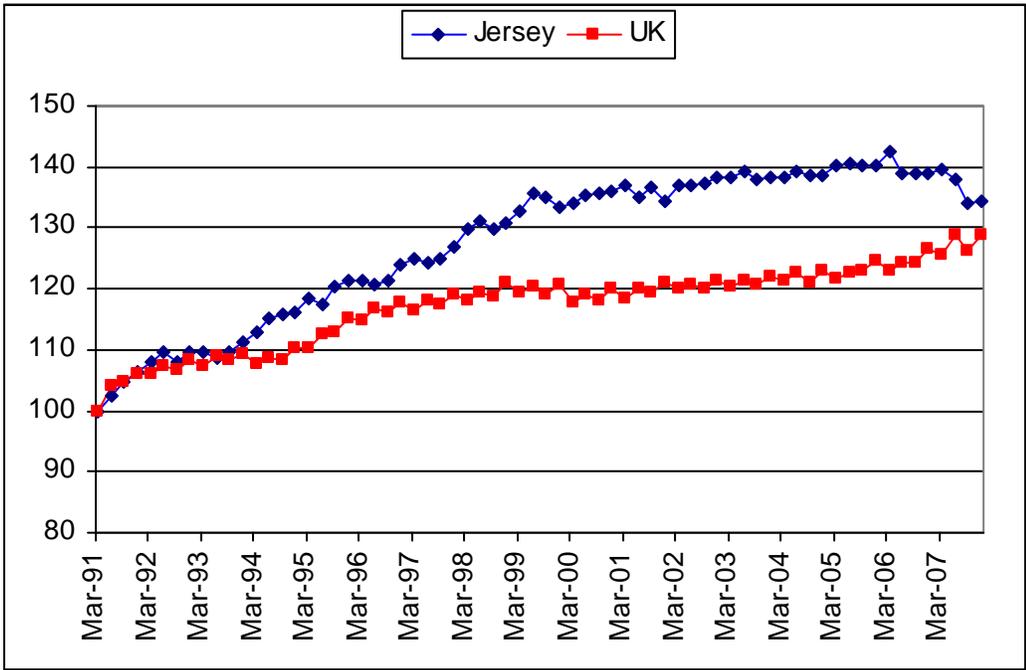
Source: States of Jersey Statistics Unit/National Statistics

Chart 16: Leisure goods prices in the UK and Jersey
 Index of prices, 1991 (1st Quarter) = 100



Source: States of Jersey Statistics Unit/National Statistics

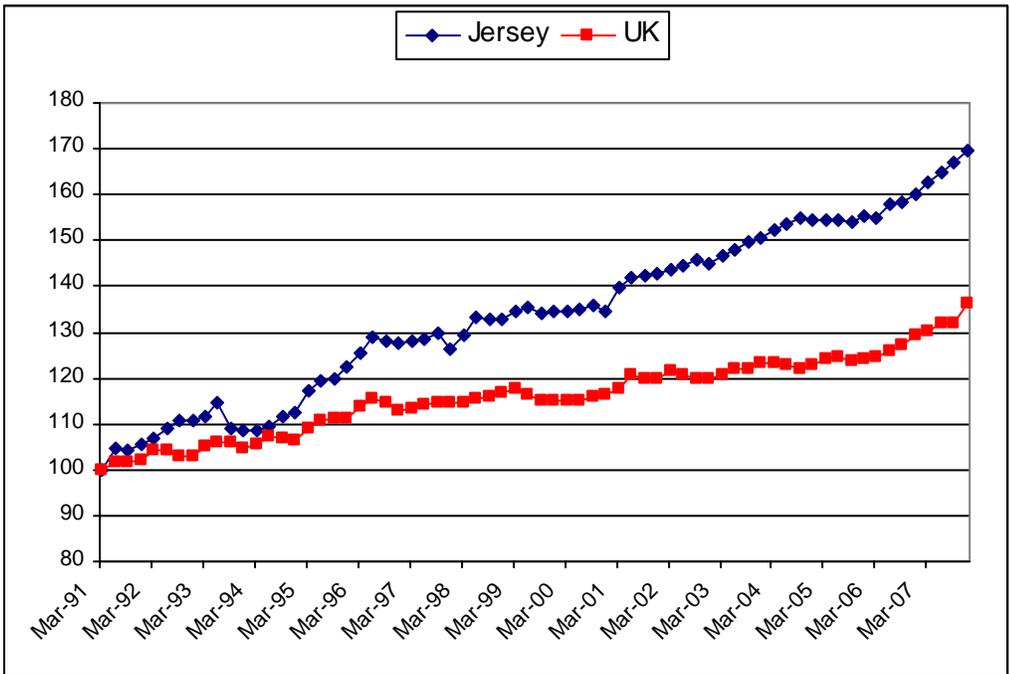
Chart 17: Household goods prices in the UK and Jersey
 Index of prices, 1991 (1st Quarter) = 100



Source: States of Jersey Statistics Unit/National Statistics

Chart 18: Food prices in the UK and Jersey

Index of prices, 1991 (1st Quarter) = 100



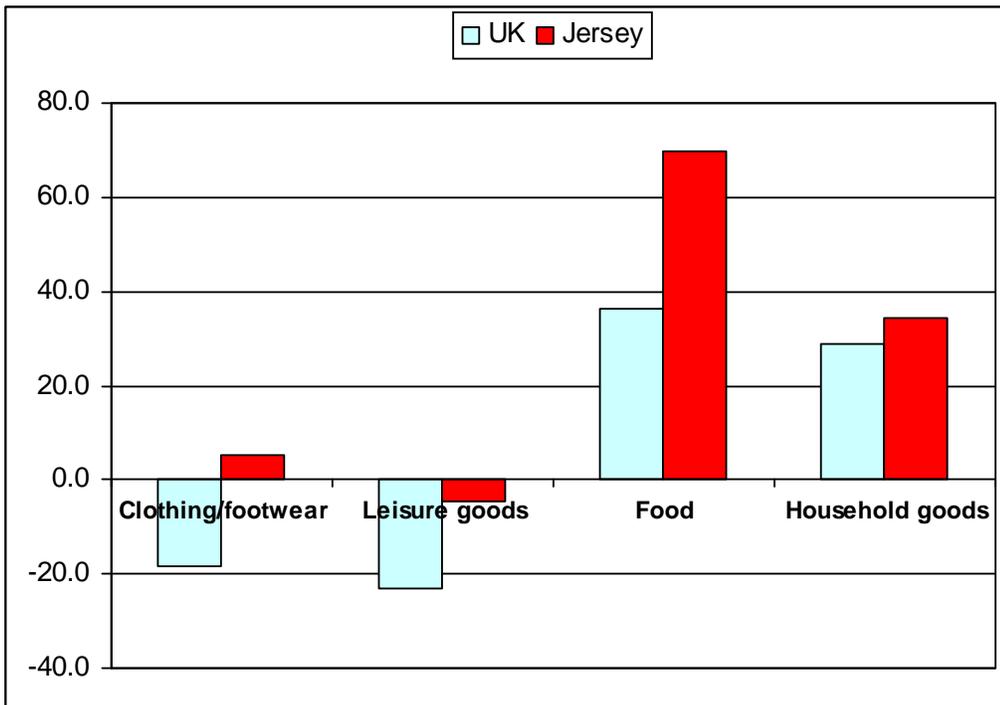
Source: States of Jersey Statistics Unit/National Statistics

The charts show that the trends in Jersey have been significantly different to those in the UK. In the first 2 cases the significant reductions in UK prices have not been matched in Jersey, although recently there have been signs that price reductions are feeding through at a greater rate in Jersey. In the second 2 cases, the low rate of increase in the UK has been exceeded in Jersey, although more recently household goods prices have moved more favourably in Jersey. In all cases, the charts above do not reflect the different levels of prices and it could be that prices were higher in Jersey than the UK at the start of the 1990s before the trends pictured above took place.

The chart below summarises these trends by looking at the percentage change in prices over the 16 year period.

Chart 19: UK trends in goods prices not reflected in Jersey

% change in RPI for selected groups, 1991-2007

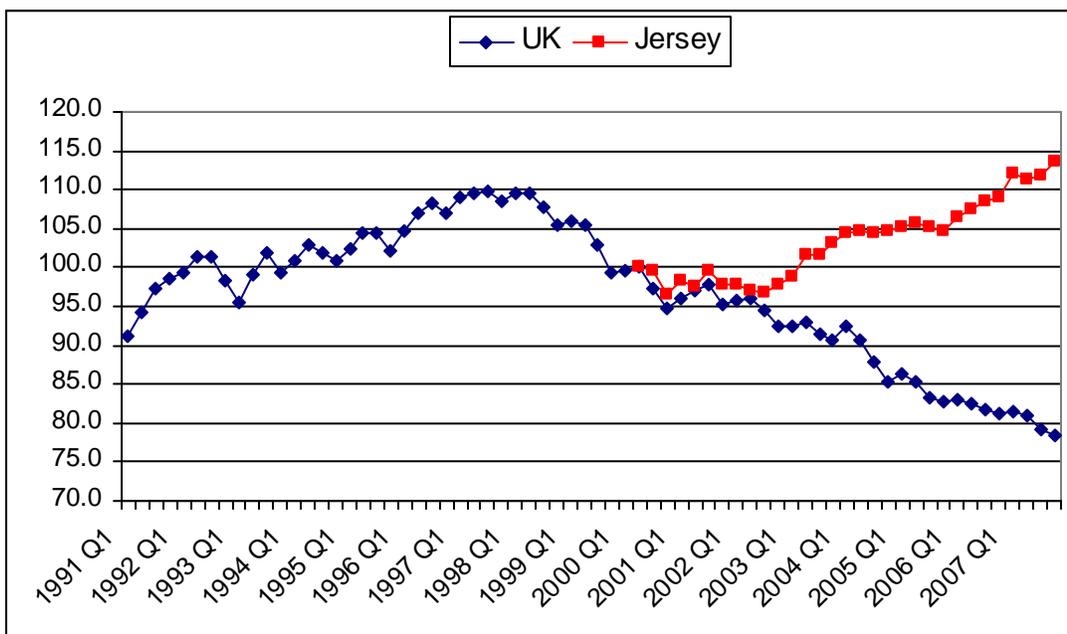


Source: States of Jersey Statistics Unit/National Statistics

The only other RPI group that has seen a below average increase between 1996 and 2007 in the UK is motoring expenditure. Further examination of this group shows another example where there has been a significant reduction in the price of a good in the UK with little or no sign of the same trend in Jersey. The chart below considers trends in new car prices in the UK and Jersey.

Chart 20: New car purchases

Index of prices, 2000 (2nd Quarter) = 100



Source: States of Jersey Statistics Unit/National Statistics

It is worth considering what these differences in price trends between the Jersey and UK could actually have meant for price levels. The table below considers what would have happened to goods valued at the same price in 1991 over the course of the next 16 years. The examples are for illustrative purposes only but show that such differences in the rate of change of price levels can feed through into material differences in price levels. It may well have been the case that the Jersey prices were more expensive in the first place and the differences are even higher in reality.

Table A: How differences in price trends impact on price levels

Item	Price in 1991	Price in UK 2007	Price in Jersey 2007
Clothing	£20	£16.40	£21.10
Camcorder	£500	£386	£478
Food	£100	£135	£170
Furniture	£500	£645	£672
	Price in 2000	Price in UK 2007	Price in Jersey 2007
New car	£15,000	£11,745	£17,025

Source: States of Jersey Statistics Unit/National Statistics

Jersey has not seen the full benefits of lower prices in the areas outlined above. Prices have therefore been sticky and have not adjusted downwards by as much as they have in the UK. Why has this been the case?

The favourable trends in the UK have been the result of falling prices of imported goods as a result of globalisation. The fact that the UK is an open economy, with competitive markets and relatively deregulated product and labour markets means that these trends have fed directly through into the prices paid by consumers. If Jersey is to benefit to the same extent from such trends it needs to also ensure an open and competitive environment.

The experience of UK car prices is an interesting case to examine. An economics paper for the DTI in 2004 by the University of East Anglia looked at a number of case studies of the benefits of competition in the UK, including that of new cars. They concluded that there was not one single clear cut event which brought about the change. However, the focal point was a report by the UK Competition Commission in 2000 along with a number of other pressures including ongoing public concern about price differentials between the UK and continental Europe and warnings from the European Commission. It is a good example of how competition policy and consumer pressure can be a powerful combination.

In 2001 the DTI outlined the key components of a world class competition regime. In the report they highlighted key research that showed that strong competition is closely linked to dynamic and efficient markets. The following box is taken from that report.

Box 1: Competition and Productivity: The Economic Evidence

Blundell, Griffith and Van Reenen (1995) and *Nickell* (1996) find that various measures of competitive pressure in a sector have a positive impact on firm efficiency and productivity growth rates.

Geroski (1990) finds evidence that market power tends to reduce the rate of innovation and productivity growth.

Caves and Barton (1990) find that increased market concentration is associated with reduced technical efficiency.

Barnes and Haskel (2000) attribute 30–50% of productivity growth in the UK and US to the entry and exit of firms in their markets.

Caves (1998) finds that new entrants bring with them higher rates of productivity.

Porter (1990) finds in his major survey of international industrial performance that it is firms which face strong domestic competition which perform best in international markets. More recent work (*Porter 2000*) shows that in Japan only those sectors characterised by strong domestic competition remain internationally competitive following the country's recent economic downturn – examples include cameras, automobiles and audio equipment.

Source: A World Class Competition Regime, DTI 2001

Since 2001 Jersey already has in place a new Competition Law that meets international standards. To ensure that the competition prevails in the economy and that productivity improvements continue to take place it will be important that all aspects of the competition framework are effective.

The lynchpin of the current competition regime is the Jersey Competition Regulatory Authority (JCRA) which has the responsibility for promoting competition and consumer interests through economic regulation and competition law. It is responsible for the regulation of telecommunications and postal operators and for administering and enforcing the Competition (Jersey) Law 2005. For Jersey competition law to have maximum effect it is clear that the effectiveness of the JCRA is vital.

The public response that helped to reduce car prices in the UK shows how important the consumer voice can be in determining efficient outcomes in the market. The experience in Jersey in recent years also shows how important consumer empowerment can be. It is only recently that the favourable price trends seen in the UK have started to occur in Jersey. There have been a number of factors that have combined to make this happen including –

- the implementation of the new competition law with a number of investigations by the JCRA;
- a successful Fair Play campaign by the JEP;
- price comparisons by the Jersey Consumer Council and States of Jersey Statistics Unit;
- increased competition from use of the internet;
- a Retail Strategy that has brought the threat of increased competition between retailers.

3.4 Trends in costs

It is often argued that the cost base in Jersey is higher than that in the UK in a number of areas and that this can explain why inflation has been higher. Such an argument confuses an explanation as to why prices might be at a higher level in Jersey than in the UK. Inflation is about the rate of change of prices so for costs to have a role in

higher inflation they must rise at a faster rate than those in the UK. The question then remains as to whether cost increases in Jersey have been greater than those in the UK and have therefore not allowed inflation to fall to the same extent as in the UK. There is incomplete data on this subject in Jersey but what information is available covers wages and salaries, fuel and light and rent and is considered below.

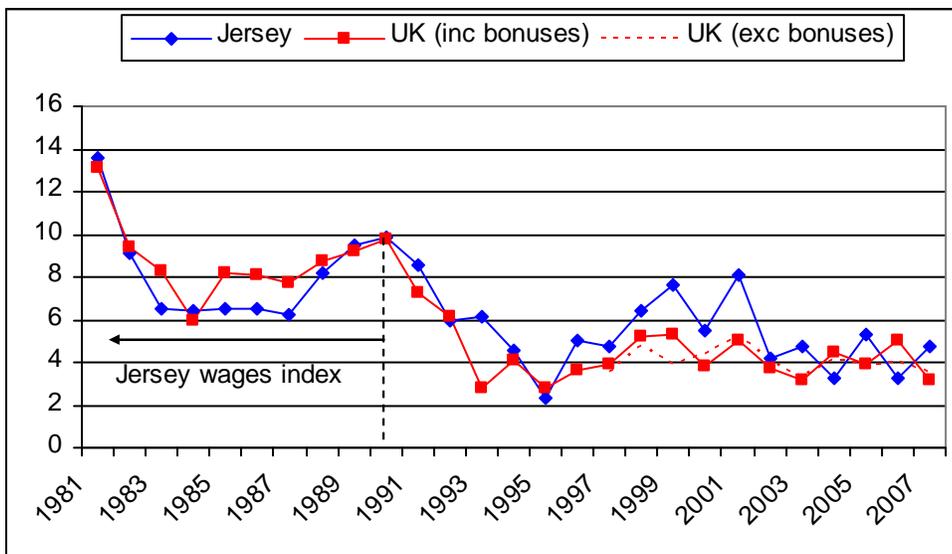
Salaries/wages

Finding directly comparable data in this area is quite difficult. The Jersey Statistics unit currently produces average earnings data which measures the changes in a gross wages and salaries paid to workers in Jersey which includes overtime payments but excludes bonuses, employers’ insurance contributions, holiday pay and benefits in kind. The data is available on a consistent basis back to 1991. However, data on a comparable basis for the UK is only available back to 1997. This does show that on average over this period, Jersey earnings have increased by 5.3% p.a. while those in the UK have increased by 4.1%. Unfortunately neither set of data helps in answering the question as to why Jersey inflation has diverged with that in the UK since 1990.

It is however possible to try and address this question by combining the comparable data with other data to give an indication of the likely trends in earnings pre 1991. The pre-1991 Jersey data is the wages index which will not be directly comparable with the earnings index as it excludes overtime payments. The UK data is earnings growth but includes bonuses (the post-1997 trend in earnings including bonuses and excluding bonuses is very similar allowing some confidence in comparing this series with that for Jersey).

Chart 21: Growth in average earnings in the UK and Jersey

% change in average earnings/wages, June each year



Source: States of Jersey Statistics Unit/National Statistics

Putting the caveats about comparing such a mixture of data to one side it is clear that over the 26 year period Jersey wages/salaries (average annual increase of 6.4%) have moved quite closely with those in the UK, although at a slightly faster rate (average annual increase of 6.0%). However, there does appear to be a clear distinction between the pre-1991 trends and those after. In the 1981–90 period, wages and salaries in Jersey increased by 8.2% on average, while those in the UK increased at a slightly sharper rate of 8.9%. In the 1991–07 period the situation changed with earnings in Jersey rising by 5.3% compared to 4.3% in the UK. The most recent data from 2003 onwards actually shows that average earnings growth has slowed again in Jersey and more in line with that in the UK. Nonetheless, analysis of the trends in average earnings would suggest that trends in the labour market do provide at least part of the explanation as to why Jersey inflation outstripped that in the UK in the 1990s and early 2000s.

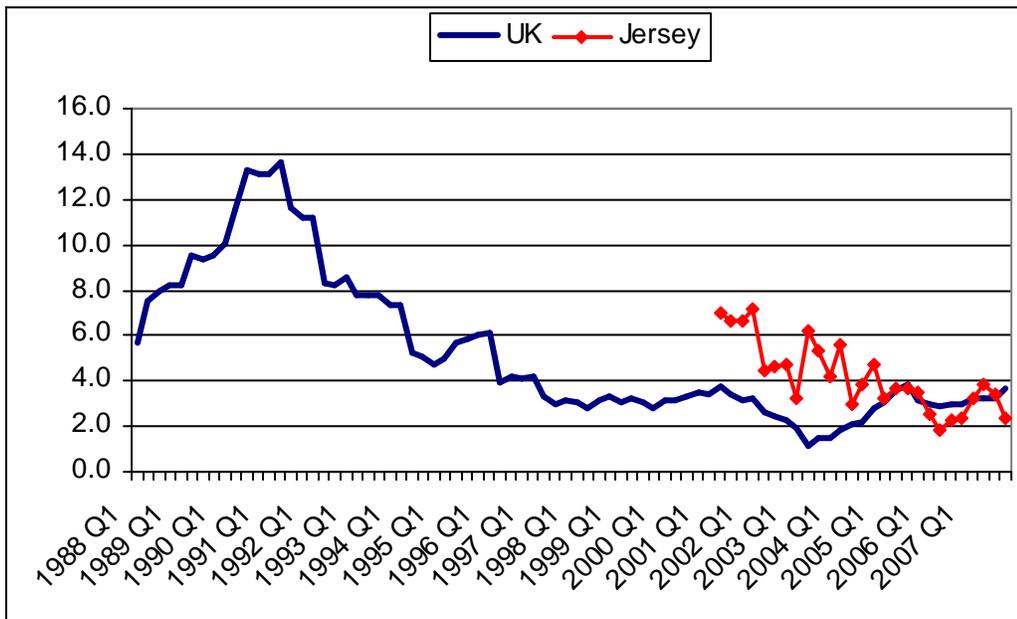
Rents

Another cost that could have experienced different trends to those in the UK is that of rent. Is there evidence to suggest that rents have not adjusted in Jersey in the post-1991 period but they have in the UK? Such a comparison is again hindered by the availability of data and the chart below compares what data there is.

There is long run data for the UK and it is clear that over the course of the 1990s rent increases have adjusted to the lower inflation environment. The only reliable data for Jersey covers the period from 2000. It does however show that in that period, Jersey rent increases have far outstripped those in the UK. Between June 2000 and September 2007, rents in Jersey increased by 35% while those in the UK increased by only 22%. Bearing in mind that there are only a few years' worth of data for Jersey, it is not possible to compare whether Jersey rental increases outstripped those in the UK in the 1990s while increases in the UK adjusted down to the lower inflation environment. However, since 2000 there have been signs that, as inflation has fallen, rent increases in Jersey have also moderated.

Chart 22: Increase in rents in the UK and Jersey

% change in rent component of RPI on year ago



Source: States of Jersey Statistics Unit/National Statistics

Fuel and light

Another important cost for individuals and businesses is that of fuel and light. Increases in such costs can feed through into wage demands and prices and can instigate cost-push inflation. The chart below looks at the trends in retail fuel and light (electricity, gas, liquid and solid fuels) prices in the UK and Jersey. These trends represent those for the prices paid by individuals rather than businesses as there is no information available on the prices they pay.

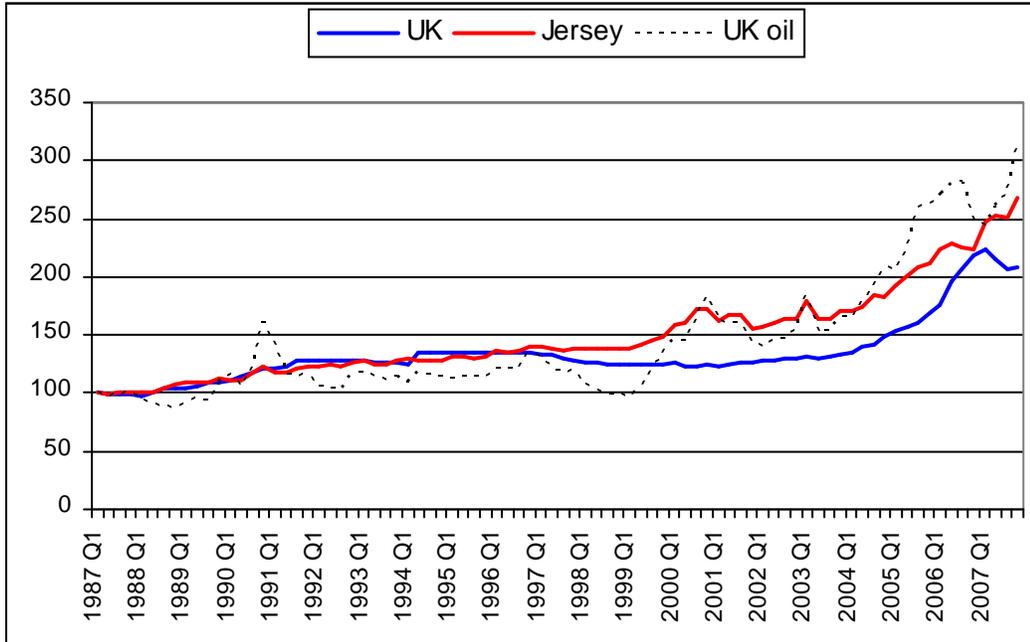
The chart shows that between 1987 and 1996 the trends in fuel and light prices in Jersey and the UK moved very closely together. However, from 1996 until the end of 2001, the prices of fuel and light in Jersey increased at a much faster rate (27%) than they did in the UK (where they fell by 8%). Between 2001 and 2007 fuel and light prices rose by 68% in the UK, compared with an equivalent increase of 54% in Jersey.

The difference in trends between the UK and Jersey will be driven to some extent by the fact that Jersey is much more dependent on oil for heating purposes and it will therefore have a larger weight in the index. The chart also includes the trends in UK oil prices as well, and this moves much more closely in line with the overall fuel and light index in Jersey. This would suggest that the different trends are driven by the fact that Jersey is more dependent on heating oil and has therefore seen a much sharper rise in fuel and light prices as a result of the increase in oil prices.

Irrespective of the reason for the sharper rise in fuel and light prices, the impact is still going to be that the different trends will feed through into the RPI in a different way and could therefore have different second-round effects if wages and other costs respond to the different trends in RPI.

Chart 23: Increase in fuel and light prices in the UK and Jersey

Index of fuel and light prices, 1987 (1st Quarter) = 100



Source: States of Jersey Statistics Unit/National Statistics

Islands have a higher costs base

It is true that small islands tend to have a higher cost base than larger economies for a number of reasons, including –

- scarceness of key resources like land and labour;
- lack of economies of scale due to the small size of domestic markets;
- higher transport costs due to remoteness/low volumes.

However, this explains why costs may be higher, but it does not explain why costs and prices may rise at a faster rate in island economies and in particular in Jersey. The analysis above has looked at the rate of change in prices, not the levels, so the high cost base argument is not an explanation for higher inflation in island economies and particularly in Jersey relative to the UK.

Indexation

One factor that could be preventing costs adjusting in Jersey is the extent to which they are indexed to inflation. Perception is that there is a high degree of indexation of wages and rents in the Island and this can prevent adjustment of such costs in times of falling inflation. This is because they are raised in line with past inflation (and the accepted norm for inflation) which means that little weight is given to recent reductions or in fact the outlook for inflation. The impact is that costs continue to rise at previous rates and that prices will go up by a greater rate than would have been the case if wages/rent had only gone up in line with inflation.

There is the additional problem that an increase in inflation will very quickly feed through into higher costs and that this can help to accelerate an increase in inflation.

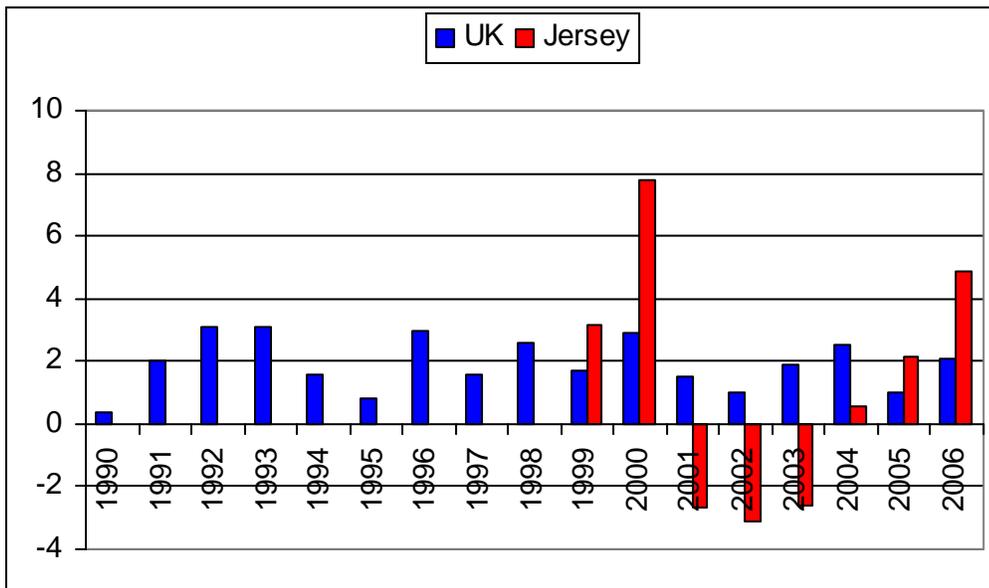
On a more positive note in a period of sustained falling inflation indexation can help to reduce increases in costs such as wages and rent. This to some extent appears to have been what has happened in Jersey in recent years, with both earnings and other costs increases slowing as inflation has fallen. The issue now though is to ensure that they do not increase again should inflation increase for whatever reason – whether it be oil prices or something else – as a continued high prevalence of indexation will mean that inflation is likely to increase more quickly in Jersey than elsewhere.

3.5 Supply side

The previous analysis has shown that inflationary pressure can result from demand rising to outstrip supply in the economy or supply contracting and failing to meet demand. If the UK economy experienced significant supply side improvements in the 1990s that were not replicated in Jersey, then that could be another reason why inflation has remained higher in Jersey.

The UK did see sustained productivity growth in the 1990s, which underpinned economic growth for that period. It is not possible to compare productivity growth in Jersey relative to that in the UK for the whole of that period. However, the chart below compares what data there is for one measure of productivity – GVA per FTE.

Chart 24: Productivity trends in the UK and Jersey
% change in GVA per FTE



Source: States of Jersey Statistics Unit/National Statistics

Throughout the 1990s and 2000s the UK experienced year after year of productivity growth. In contrast in Jersey the trend has been more volatile. GVA per FTE fell after 2000 as the economy weakened, but has increased again as the economy has expanded. Over the 1999–2006 period, productivity growth in Jersey averaged 1.3% compared to 1.8% in the UK.

Another way of looking at the supply side performance is to consider the amount of spare resources that are available in the economy. If there is more spare land and labour in an economy, then assuming they are suitable for use then there will be more scope for sustained growth. It is hard to compare the situation in terms of land availability as there is not much data available.

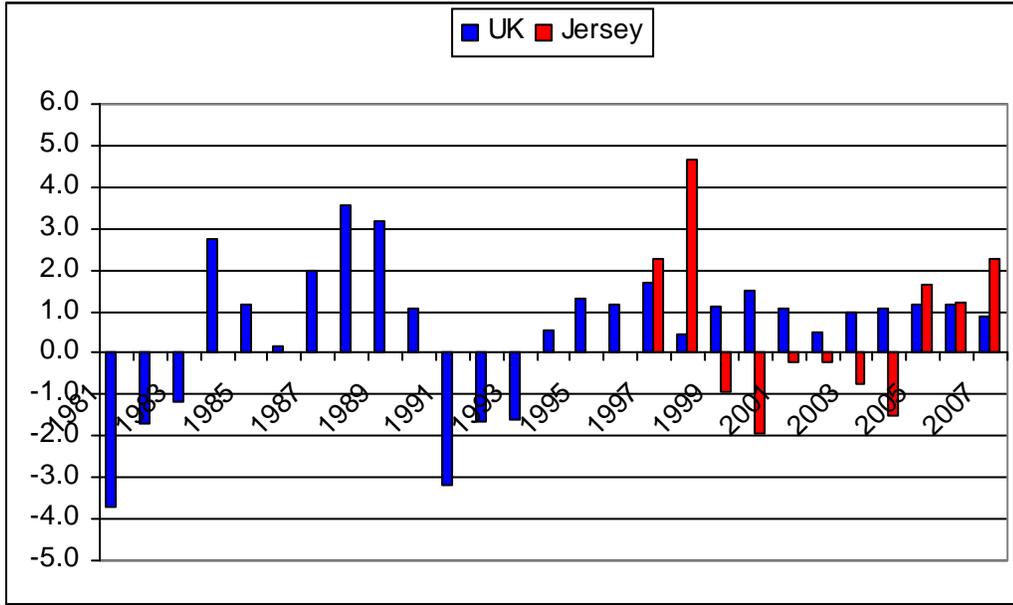
There is no simple way of comparing the availability of land in the Jersey economy relative to the UK. We do know at a very broad level population density in Jersey is 3 times that of the UK. There is also a body of evidence that shows house prices and rents are higher in Jersey than the UK average, and provided that the data are not distorted by other factors would appear to indicate that land is more scarce in Jersey, suggesting that again growth in the Island is more constrained by the availability of land and that this could contribute to higher inflation in the

Island. It is however, easier to look at the labour market situation.

The chart below shows that the UK’s strong economic performance in the 1990s coincided with continued growth in employment. In Jersey, employment data only goes back to 1996 but it is clear that trends have been more volatile with employment varying across the economic cycle. Over the 1997–2007 period, employment growth in the UK was 1.1% p.a. nearly double the 0.6% achieved in Jersey.

Chart 25: Employment growth in Jersey and the UK

% change in employment

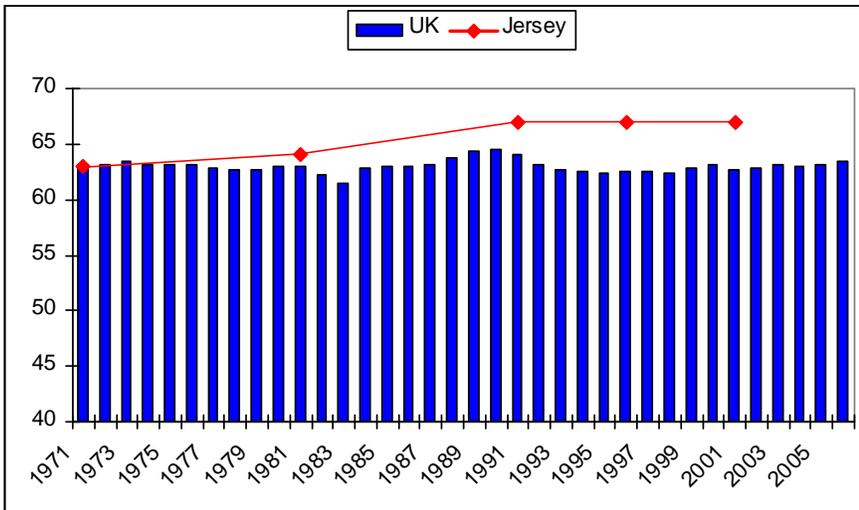


Source: States of Jersey Statistics Unit/National Statistics

Data from the census in Jersey provides a longer run of information on labour market participation and the chart below shows that Jersey saw a significant increase in labour market participation between 1971 and 1991 but then no further improvement in the subsequent years. In the UK, participation did not increase by the same degree up to 1991 but also dipped in the early 1990s allowing some further improvement in the late 1990s and early 2000s. The end product is that throughout the 1990s and early 2000s it is apparent that Jersey had much higher participation rates which indicates a tighter labour market than was the case in the UK.

Chart 26: Participation rates in the UK and Jersey

Activity rates for males and females aged 16 and over, % of population 16+



Source: States of Jersey Statistics Unit/National Statistics

Population data shows that over the course of the 1990s and 2000s there have been different trends in population and migration between the UK and Jersey. Between 1991 and 2006 the UK's population increased by 5.4%, compared to 6.2% in Jersey. However, the demographic trends underlying these population trends have been significantly different.

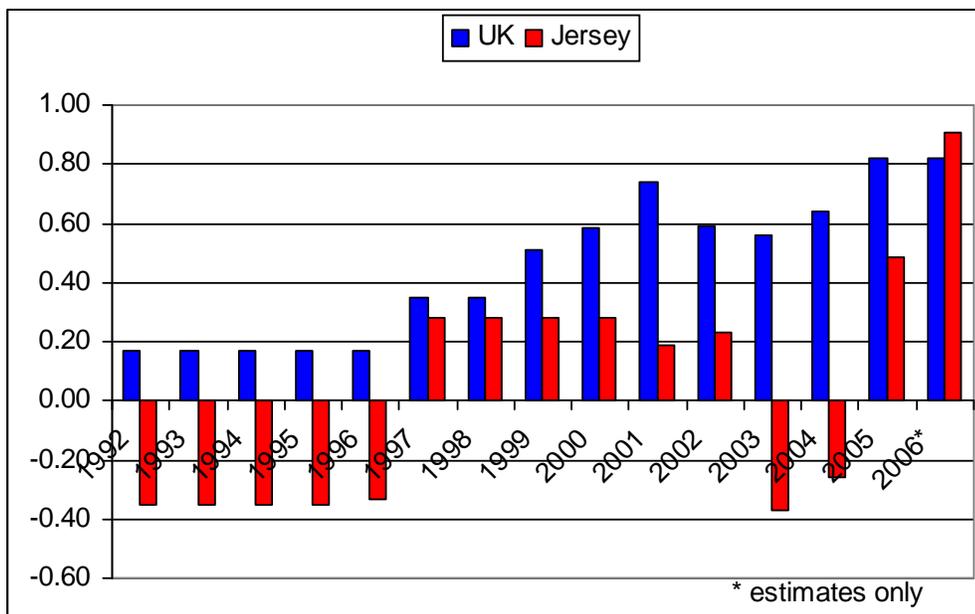
Firstly, over the same period there has been sustained inward migration in the UK that amounted to about 1.9 million people. In Jersey, there have been periods of net outward migration and net inward migration that largely cancel each other out as there has only been net inward migration of 700 people over the 1991–2006 period.

Secondly, the combination of inward migration and demographic trends have meant that the UK has also seen sustained growth in the working age population (see Chart below). On the other hand, Jersey has seen very little growth in the working age population. This means that over the same period, the UK has seen a fall (improvement) in its dependency ratio (albeit from a higher level) while Jersey has seen a gradual rise (worsening) in its dependency ratio.

This growth in the working age population highlights one reason why the UK has been able to see sustained employment growth over the same period. This represents an improvement in the supply capability of the UK economy that was not replicated in Jersey over the same period.

Chart 27: Changes in the working age population

% change in working age population (ages 16–64 males and 16–59 females)



Source: States of Jersey Statistics Unit/National Statistics

3.6 Housing market

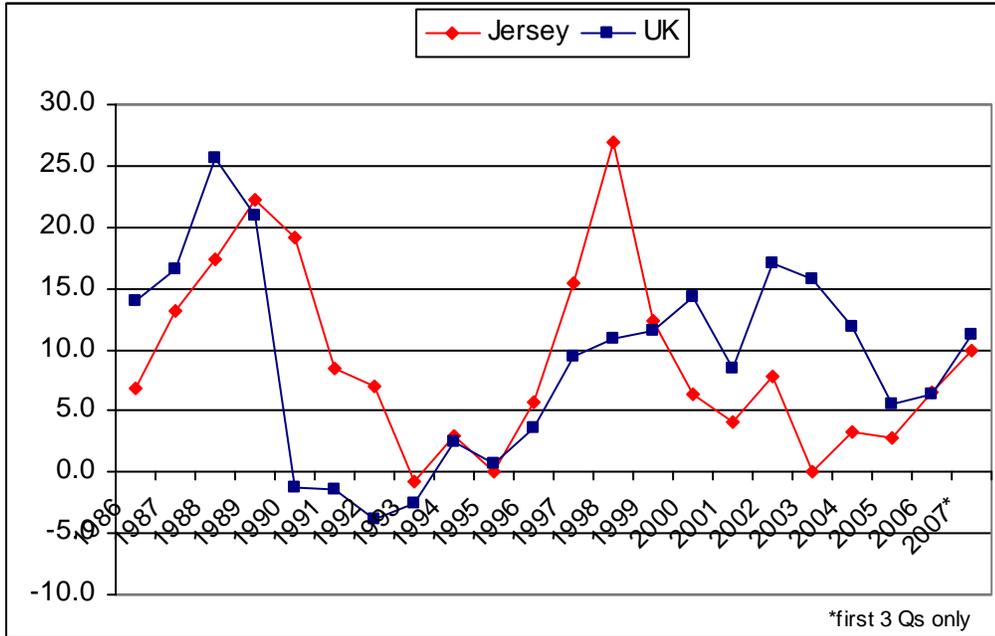
Trends in the housing market can have a significant impact on inflation in the Island as rising house prices feed directly into the RPI (through mortgage costs and imputed rent). Higher house prices can bolster demand in the economy through wealth effects (homeowners consume more as the price of their house increases and their wealth with it). But rising house prices can also impact on the supply side through the cost of living (and hence wage demands) and labour mobility. Have trends been different in the UK and Jersey?

If we are considering what might have contributed to higher inflation in Jersey than in the UK over the course of the 1990s and early 2000s, it is worth considering what happened to house prices. The chart below shows that

although the housing markets have not moved in tandem, the end result has to some extent been the same. While increases in house prices have been stronger in Jersey in the early 1990s and late 1990s, increases in the UK have been above those in Jersey in the 2000s. Over the period shown in the Chart, house prices in the UK and Jersey have both increased by an average of 9% a year.

Chart 28: House price trends in Jersey and the UK

% change in mix adjusted price



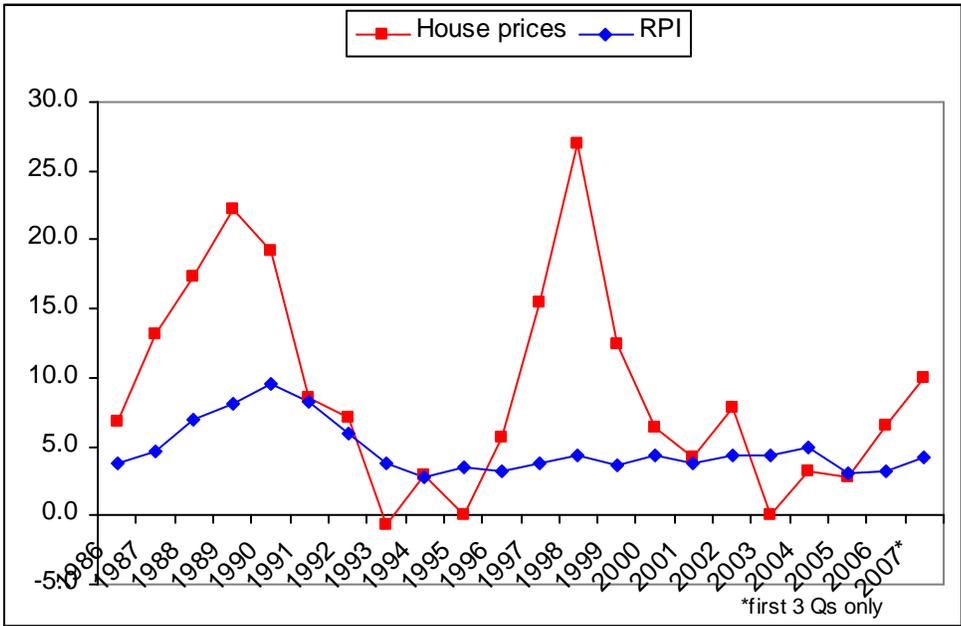
Source: States of Jersey Statistics Unit/Office of Deputy Prime Minister

When these trends above are considered alongside the inflation performance of the 2 jurisdictions there does seem to be some correlation. That is, over the course of the 1986–99 period, house price inflation in Jersey was 11% p.a. compared to 8% in the UK. In the 2000–07 period, the situation changes with house price inflation in the UK averaging 11% p.a. compared to 5% in Jersey.

The Chart below also looks at the correlation between Jersey’s rate of inflation and house price increases. It shows that high inflation and high house price inflation went hand in hand in the early 1990s. In the late 1990s, the peak in house prices inflation only corresponded with a gradual increase in inflation, which continued even after house price increases had slowed. The recent rise in house prices has not been accompanied by an increase in inflation.

Chart 29: House prices and inflation in Jersey

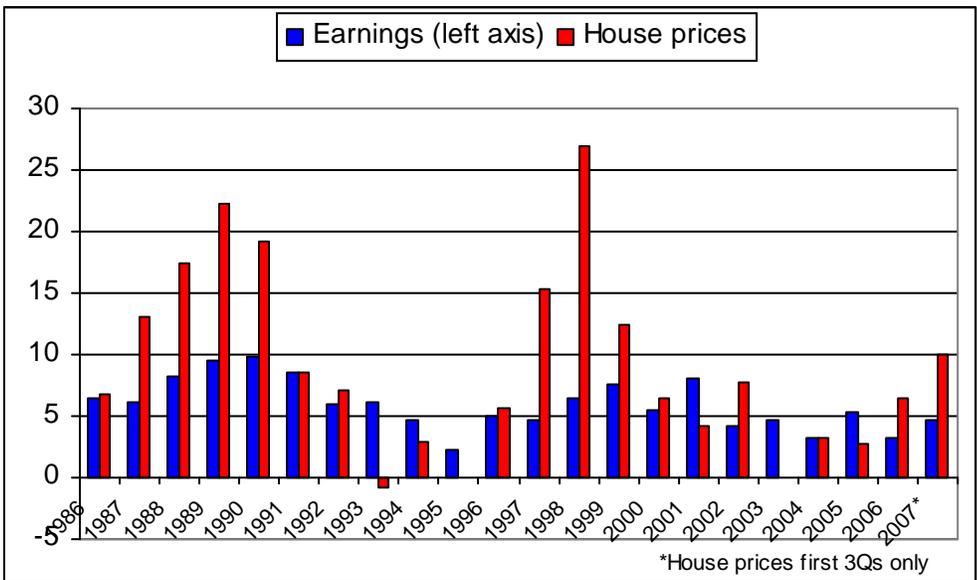
% change in mix adjusted price



Source: States of Jersey Statistics Unit

To consider whether house prices can feed through into cost push pressures it is worth considering the trends in average earnings growth and house prices. The Chart below looks at these trends and shows that there is quite a strong correlation between growth in average earnings and house prices, and that very strong growth in house prices tends to coincide with an increase in earnings growth. However, this does not necessarily prove the direction of causation. They are both likely to increase at times when the economy is performing strongly – labour will be in shorter supply and demand for houses will be high. It is worth noting also that when house price growth slowed significantly in the early 2000s that there was some slowing in average earnings growth but it still persisted in the 4% range.

Chart 30: Average earnings and house prices increases in Jersey
 % change in mix adjusted price, % change in average earnings



Source: States of Jersey Statistics Unit