Jordan—2008 Article IV Consultation

Concluding Statement of the IMF Mission[1]

March 11, 2008

The authorities have taken bold steps to reduce pressure on the budget by removing the fuel subsidy. The key near-term policy challenges are to bring inflation back down quickly and to mitigate risks related to fiscal and external vulnerabilities.

1. The Jordanian economy continued to perform well in 2007. Economic growth is estimated at close to 6 percent for the year, and the unemployment rate has continued to come down. Foreign Direct Investment (FDI) inflows remained strong and international reserves increased substantially. Inflation, which had picked up following the fuel price adjustment in 2006, declined from almost 9 percent (year-on-year) in early 2007 to below 4 percent by mid-year.

2. Rapidly rising international fuel and food prices put pressure on the fiscal and external accounts, especially in the second half of the year. Despite increases in some administered food prices in late-2007, food and fuel subsidies increased sharply and, together with a shortfall in grants, led to a deterioration in the overall fiscal deficit. This was reflected in a widening of the external current account deficit in the latter half of 2007, which was exacerbated by rising import prices as well as labor and cost pressures that reduced textile exports. Inflation also started to pick up in late-2007, reaching 5.7 percent (y-o-y) by December.

3. The outlook for 2008 is generally favorable, but tighter macroeconomic policies are needed to mitigate inflation risks and reduce fiscal and external imbalances. Real GDP growth is expected to ease slightly to 5½ percent, with continued robust activity in the construction and tourism sectors broadly offsetting weaker external demand. After jumping on account of the recent fuel price adjustment, inflation is projected to moderate to 9 percent (y-o-y) by December, assuming the fiscal measures presently envisaged by the authorities are implemented. Despite high import prices and weakness of textile exports, the current account deficit is projected to narrow moderately due to a recovery of grants and buoyant prices of mining exports. Continued strong FDI and portfolio flows are expected to finance the deficit.

---

[1] An IMF mission team visited Jordan during February 27–March 11 to conduct the discussions for the 2008 Article IV consultation. The mission reviewed macroeconomic developments and changes to the economic outlook since the last consultation. This statement represents the views of the mission team, not necessarily those of the IMF. The views may evolve as the assessment presented in the staff report on Jordan is produced.

4. The authorities' intention to tighten fiscal policy is appropriate. In response to the widening imbalances, they took the bold but necessary step to eliminate fuel subsidies in February 2008. Together with a one-time fuel price adjustment of 47 percent on average, a mechanism for monthly adjustments in response to international price developments was put in place, removing the vulnerability of the budget to further oil price movements. To ensure public acceptance of the subsidy removal and protect vulnerable groups, compensatory expenditure measures of 3.5 percent of GDP were also taken. The compensatory measures include an increase of public sector salaries and pensions as well as an expansion of social safety net transfers. Without a tightening of policy, the fiscal position would deteriorate even if capital expenditures are not fully executed. Recognizing this, the authorities intend to take additional measures of about 1 percent of GDP in order to achieve the original budget target for the deficit of JD724 million (5.5 percent of GDP) in 2008. Achieving this target—which requires continued full operation of the new fuel price adjustment mechanism and resisting new spending pressures—will be critical for bringing inflation down, reducing the external imbalance, and preventing a crowding out of private credit that could dampen overall growth.

5. Further consolidation of the public finances will be needed over the medium term to reduce the fiscal imbalance to a more comfortable level. To this end, parliament's recent approval of the revised public debt management law, which enshrines the authorities' existing medium-term debt targets, is welcome. Nevertheless, even with the envisaged tightening this year, the overall public debt ceiling of 60 percent of GDP in 2011 is likely to just be met and the budget deficit would remain above 4½ percent of GDP over the medium term. Given that the upcoming Paris Club buy-back is providing some upfront debt reduction (see below), and to leave some cushion for possible unforeseen demands on the budget, gearing fiscal policy toward a more ambitious target would be appropriate and achievable. For example, limiting the growth of salaries and pensions to 3 percent in real terms would reduce the deficit to 2 percent of GDP by 2013 and public debt to 51 percent (56 percent in 2011), achieving a significant reduction of fiscal vulnerability. Given the high level of government spending relative to the size of the economy (over 40 percent of GDP at present), fiscal expenditure restraint would also create needed space for the private sector and strengthen medium-term growth prospects. In addition, fiscal consolidation would help narrow the current account deficit more rapidly and reduce vulnerability to a sharp drop in capital inflows.

6. A planned $2 billion debt buy-back at end-March will reduce the large external debt burden, improve its currency composition, and send a positive signal to investors and rating agencies. The operation, which will cover non-concessional Paris Club debt, is expected to be financed by saved privatization proceeds (about $1.5 billion) and external grants ($0.5 billion). Foreign reserves, which are expected to decline as the privatization account is drawn down, will remain very comfortable in relation to short-term external debt, although their import cover ratio will decline to 3.7 months.

7. The exchange rate peg continues to serve as a strong anchor for monetary policy, and there does not appear to be clear evidence of misalignment. Given inflation risks, the authorities have appropriately allowed interest rate differentials against U.S. dollar rates to widen in recent months. While there has been some switching from foreign to domestic currency deposits, official reserves have remained broadly stable and the Central Bank of Jordan (CBJ) has not so far needed to step up its sterilization operations. As long as short-term capital inflows remain limited, tighter monetary policy would keep inflation expectations in check. In order to determine the appropriate volume and frequency of Certificate of Deposit (CD) issuance to achieve the desired increase in CD rates, close coordination with the issuance of government debt to finance the budget will be critical. Higher policy rates would also aid in curbing banks' loan-to-deposit ratios, which have been edging up.

8. Banking supervision remains strong and banking sector risks appear manageable. Banks are well capitalized, non-performing loan ratios are low, and strict loan classification and provisioning rules require banks to maintain adequate loan-loss provisions. Although the share of credit to the construction sector and to purchase stocks has increased in recent years, appropriate prudential regulations are in place to curb banks' exposure to the real estate sector and the stock market. Limits are also in place on banks' open foreign exchange positions, and banks may only lend in foreign currency to clients with export earnings. Thus, the share of foreign currency loans remains low, and banks' incentives to mobilize relatively inexpensive foreign currency funding appear muted. To prevent a further increase in the loan-to-deposit ratio, especially of some of the smaller banks that presently have relatively high ratios, prudential limits on the sources versus uses of funds that are under consideration should help mitigate risks. In addition, they will likely act to curb credit growth, thereby reducing inflationary pressure.

9. On the structural side, the CBJ has made significant progress in strengthening the regulatory and institutional framework for the banking sector in recent years. The implementation of Basel II standards is now underway (from 2008). The enactment of an anti-money laundering (AML) law in 2007 and the establishment of an AML unit in the CBJ, new corporate governance regulations for banks, implementation of the electronic check-clearing system, and publication of the Financial Stability Report are welcome developments. The envisaged enactment of credit bureau legislation will also boost the further development of the financial system. The recent establishment of a Dow Jones index for the Amman Stock Exchange will enhance the development of the broader capital market, as will efforts to deepen the secondary debt market. A mission to conduct a Financial Sector Assessment Program (FSAP) update is expected this year, which should help prioritize future reforms.

10. Important reforms have also been implemented in the fiscal area. These include the introduction of a new chart of accounts, preparation of an integrated medium-term expenditure framework, and enhancement of the macro-fiscal unit in the Ministry of Finance (MOF). In addition, the public financial management system is being strengthened, with recent progress on

implementing the single treasury account and the Government Financial Management Information System (GFMIS) expected soon to move into the implementation phase. The mission notes recent progress in addressing the longstanding issue of the government's overdraft facility with the CBJ, and urges its expeditious resolution to enhance the independence of the central bank and strongly signal the authorities' resolve to rein in the fiscal position.

11. Structural reforms in other areas are also underway and will help sustain strong economic performance. Following the successful initial public offering for Royal Jordanian and the privatization of three electricity companies in recent months, the Privatization Commission is now turning its attention to establishing a regulatory framework for public-private partnerships (PPP) to attract private financing for public investment projects. Risks to the budget, through actual as well as contingent commitments, from PPP projects need to be assessed carefully, and the inclusion of Ministry of Finance (MOF) representatives on the PPP approval committee is welcome. The plan to fully liberalize the petroleum sector over the next 2-3 years will reduce fiscal risks and improve the efficiency of resource allocation. The authorities are also considering reforms to the social security system that aim at improving the actuarial soundness of the pension system.

12. The mission urges early progress in resolving the remaining issues that are delaying subscription to the Special Data Dissemination Standards (SDDS). Coordinated effort by the MOF and CBJ to align the coverage of budget revenues and expenditures with government financing flows will also facilitate the assessment of fiscal developments and policy stance. The compilation and timeliness of wages and earnings data is being enhanced to meet SDDS requirements, and the provision of adequate resources to the Department of Statistics will be important to ensure timely completion of this and other key data initiatives. The mission welcomes the authorities' interest in strengthening their debt management strategy and practices, and is pleased to confirm that a joint IMF/World Bank technical assistance mission will visit Jordan in April.

****

It remains for us to thank you for your warm hospitality and the candid and productive policy discussions over the past two weeks. We wish you continued success in managing Jordan's economy.