Jordan—2010 Article IV Consultation, Concluding Statement of the IMF Mission

July 17, 2010

Following a decade of strong growth, the Jordanian economy has slowed (with output growth falling below potential), largely due to the global and regional downturn. Economic activity is expected to pick up modestly in 2010, as growth revives in key regional trading partners. Notwithstanding the authorities' strong fiscal consolidation efforts, and prudent regulation and supervision of the financial sector, policies need to remain focused on guarding against fiscal and external vulnerabilities.

1. **An International Monetary Fund mission visited Amman between July 6-18, 2010 to hold discussions for the 2010 Article IV consultation.** The mission met with the Prime Minister, the Minister of Finance, the Governor of the Central Bank of Jordan (CBJ), the Ministers of Planning, Tourism, and Public Sector Development, senior government officials, as well as representatives of the financial sector, non-financial private sector, and donors. The mission thanks the Jordanian authorities for their warm hospitality and open and constructive policy discussions, and wishes the government and people of Jordan continued success.

Background and Economic Developments

2. **The global economic downturn adversely affected economic activity.** Real GDP growth fell from 7⅓ percent in 2008 to 2⅓ percent in 2009. Headline inflation declined steadily through 2009 to near zero, in line with lower world commodity prices, although core inflation remained stable at around 3 percent year-on-year (y-o-y). Lower world commodity prices also helped reduce the current account deficit to about 5 percent of GDP in 2009 (from 9⅔ percent in 2008). Official foreign reserves continued to increase, reaching a record high of $11 billion (equivalent to 8¼ months of imports) at end-2009.

3. **Despite an expected modest rebound in economic growth in 2010 to about 3½ percent, output growth remains well below potential, reflecting slowly-recovering global and regional conditions.** Inflation picked up to 5⅓ percent y-o-y in June 2010, driven mostly by higher international fuel and food prices. The current account deficit is expected to rise in 2010 (reaching almost 7 percent of GDP), as higher expenditure

on imported commodities is partially offset by healthy tourism receipts and a rebound in exports.

4. **Near-term risks to the economic outlook remain tilted to the downside, given uncertainties regarding world commodity-price developments, as well as fragile regional and global economic conditions.** If the economic recovery in Gulf Cooperation Council (GCC) countries—to which the Jordanian business cycle is closely linked—proves to be slower than anticipated, this may adversely affect external flows. Developments in Southern Europe will likely have little impact on Jordan—any direct spillover through financial channels would be limited since Jordan's financial sector has no substantial links to European assets. Similarly, the European share of total Jordanian exports, remittances and tourism receipts is relatively small. Indeed, further appreciation of the U.S. dollar vis-à-vis the euro may have a positive impact on the Jordanian external position, since imports from European Union countries account for almost one quarter of total Jordanian imports.

Fiscal Policy

5. **In common with many emerging market countries adversely affected by the global growth downturn, Jordan's already-difficult 2009 fiscal position was made worse by a significant deterioration in external grants.** While an increase in capital spending—to support domestic activity—was largely offset by lower commodity subsidies, a cyclical weakening in domestic revenues and a dramatic downturn in external grants induced a widening of the overall deficit by more than 3 percentage points of GDP, reaching 8½ percent of GDP in 2009. As a result, the debt-to-GDP ratio rose to about 56 percent at end-2009.

6. **The mission supports the authorities' fiscal stance for 2010, which envisages substantial consolidation.** Based on the latest developments and macroeconomic assumptions, the 2010 overall deficit is expected to narrow by more than 2 percent of GDP relative to the 2009 outturn, reaching about 6 percent of GDP. With lower projected grant receipts and the continued cyclical decline in tax revenues, the consolidation will come mainly from the spending side—involving greater prioritization of capital spending and savings in current expenditures, including from containment of the public sector wage bill. Supplementary revenue measures—raising indirect taxes on petroleum and other commodities, and reversing the GST exemption for coffee—will partially offset commitments not sufficiently accounted for in the budget, including expenditures on the National Aid Fund, commodity (LPG and bread) subsidies, and teachers' remuneration. Policy actions for 2010 which demonstrate the Government's commitment to fiscal consolidation include: reducing operational costs of Ministries; cessation of construction of new government buildings, excepting schools and hospitals; and cutting Ministerial salaries by 20 percent. Implementation of these fiscal

plans would result in a modest uptick in the public debt-to-GDP ratio, which would nonetheless remain below the 60 percent legislated debt ceiling.

7. **As output growth recovers and comes closer to potential in 2011-13, macroeconomic stability will continue to hinge upon a prudent fiscal policy.** Without substantial consolidation, the fiscal deficit would remain sizable and the public debt-to-GDP ratio would continue to edge up. Fiscal consolidation will also help contain the external current account deficit and free up domestic resources to support private sector-led growth—this can be achieved only by further fiscal adjustment in 2011 and beyond. The mission supports the authorities' policy proposals which (beginning in 2011) would reduce the overall balance by between one-half and one percent of GDP per year (depending on the level of economic activity), and help achieve an overall deficit of about 3 percent over the medium term. Priorities underpinning this adjustment are policies aimed at removing remaining tax exemptions on commodities, continuing moderation of growth in the wage bill, improving the efficiency of current spending, and ongoing prioritization of capital spending. The authorities' proposed set of policies would reduce the debt-to-GDP ratio to about 53 percent by 2015. Such adjustment will be crucial to maintain investor confidence, preserve macroeconomic stability, and create scope for potential future countercyclical fiscal policy.

Monetary and Exchange Rate Policy

8. **While monetary easing in 2009-10 to stimulate domestic demand has been appropriate, there is likely little room for further monetary stimulus.** Since late 2008, the authorities have taken several prudent steps to sustain confidence and support the domestic financial system. These include a full guarantee of bank deposits, cessation of liquidity-mopping operations, and cuts in the policy interest rate and reserve requirements. With international reserves large and stabilizing, and given the continuing revival of bank private sector credit (which grew by 5½ percent y-o-y in May 2010), further easing of monetary policy is likely to have a limited policy impact as the interest differential with U.S. rates has fallen, and inflationary pressures are emerging. Moreover, imperfect monetary transmission and uncertainty in transmission lags warrant a cautious approach to further policy interest rate changes.

9. **The CBJ should continue to stand ready to tighten monetary conditions if inflation accelerates or there are signs of pressure on the balance of payments.** Recent increases in headline inflation have been largely due to rising international food and energy prices, which are not likely to be driven by excessive domestic demand. However, persistently high headline inflation does risk inducing inflationary momentum through its effect on inflation expectations. Balance of payments pressures could call for a tightening of monetary policy in support of the international reserve position. Monetary tightening could be implemented by increasing reserve requirements (to

reduce excess reserves held at the overnight window), by operations to soak up excess banking system liquidity (through resumption of issuance of certificates of deposit), and by raising the policy rate.

10. **The exchange rate peg provides an appropriate nominal anchor and remains the key pillar of financial stability.** The Jordanian dinar's peg to the U.S. dollar has played an indispensable role in anchoring inflation expectations and providing for financial stability in a volatile region. While the U.S. dollar has recently strengthened against major currencies, inducing an appreciation of the real effective exchange rate by 1 percent between December 2008 and May 2010, the mission's analysis of the real effective exchange rate suggests that the dinar remains broadly aligned with medium-term fundamentals.

Financial Sector

11. **The Jordanian banking system remains sound and has proven resilient to the global financial crisis.** The CBJ's prudent banking regulation and supervision, and banks' conservative funding practices (with loan/deposit ratio near 75 percent) have shielded domestic banks from exposure to troubled international banks, structured products, and wholesale financial markets. The banking sector's macroprudential indicators remain strong–banks remain profitable and well capitalized, deposits continue to be the major funding base, liquidity ratios and provisioning remain high, while NPL ratios increased modestly to 6⅔ percent of outstanding loans at end-2009. However, banks could be exposed to higher non-performing loans and provisioning requirements over the medium term, as Jordan's growth path is likely to remain below potential in the period to 2013.

12. **Effective banking supervision has strengthened the capacity of Jordanian banks to withstand shocks.** The mission welcomes measures taken by the CBJ to further enhance its effective banking supervision, including: introduction of Basle II (Pillars I and III) regulations in 2008, and ongoing efforts to ensure compliance of banks with Pillar II guidelines for risk management (issued in February 2010); requiring semi-annual stress testing of banks (issued in September 2009), examining in particular credit risk and concentration risk, with aggregated results reported transparently in the CBJ's *Financial Stability Report*; introduction of an automated data collection system, to improve off-site monitoring of banks (June 2010); enhanced cross-border bank regulation through regular supervision and on-site inspections of international branches and subsidiaries of Jordanian banks; and improvements to its early warning system. Upcoming IMF technical assistance will provide further help in Basle II implementation. In addition, the authorities passed the law establishing a private credit bureau (June 2010), which should promote bank and non-bank private credit flows.

13. **The authorities have recently strengthened their Anti Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework.** Jordan is pursuing its efforts to strengthen its AML/CFT system according to the standards of the Financial Action Task Force (FATF). Major components of this strengthening involved: amending the anti-money laundering law in May 2010; issuing regulations that grant the Financial Intelligence Unit greater independence; and adopting a cash declaration system at the borders in March 2010.

Structural and Other Issues

14. **Progress in structural reforms is a major policy goal to reduce fiscal and external vulnerabilities, while achieving higher economic growth and employment over the medium term.** Further improving the business environment for the private sector should help raise productivity and reinforce Jordan's competitiveness. In this connection, in early 2010 the Jordanian Cabinet passed legislation that lowers the average tax burden and enhances the investment climate. The mission noted that these are steps in the right direction and need to be supported by additional structural reforms to maintain future competitiveness. In May 2010, the authorities made commendable strides by undertaking reforms of the social security system that improve the sustainability and actuarial soundness of their pension scheme. In addition, the revised social security law introduces unemployment insurance to social security recipients, which should enhance labor market flexibility (commencing July 2011). Other structural reform priorities should include further liberalization of the water and energy sectors, and completion of civil service reforms (which the authorities are embarking upon with technical assistance from the World Bank and USAID).

15. **With a sound institutional framework in place to control for fiscal risks, public-private partnerships (PPPs) can provide a useful vehicle to address infrastructure bottlenecks in a tight fiscal environment.** The authorities' ambitious program of large-scale infrastructure development, particularly in the provision of power, water, and rail transportation infrastructure, is to be financed by PPPs. While PPPs can offer better value for money in the provision of public infrastructure, international experience has demonstrated that they can also generate potential fiscal liabilities. Before committing to potential public liabilities, the mission recommends that a number of preconditions be put in place, including improving existing PPP regulations to approve a legal framework that ensures adequate risk transfer to the private sector and prescribes a clear process for the evaluation and approval of PPPs. Other elements of a sound PPP framework would include competitive bidding procedures, capacity-building at the government level, and proper accounting and reporting of fiscal implications. The authorities are currently in the process of strengthening an earlier framework law for PPPs, which will be submitted to Cabinet later in 2010.

16. **Fiscal institutions should continue to be strengthened.** Progress in public sector structural reforms is critical to enhance the business environment for private sector-led growth. The mission recommends that accelerated steps be taken to improve public sector financial management through: further strengthening the medium-term framework for budget formation and implementation; introducing the Government Financial Management Information System across government ministries; and improving cash management through full implementation of the Treasury Single Account. In addition, as the number of autonomous public agencies increased to 61 by end-2009, structural reform of overall public expenditure policies will be needed to reduce the burden of government entities on the budget.

17. **Given Jordan's large stock of public debt, formation and communication of the government's debt reduction and debt management strategy will be critical.** The authorities have taken steps to enhance the efficiency of debt issuance by increasing the number of Treasury bill and bond auctions and reducing the size of offers, and by moving toward the establishment of a debt auction calendar. Going forward—in line with IMF technical assistance recommendations—the government should accelerate its efforts to: formulate and communicate a medium-term debt management strategy; establish a robust middle-office function within the Ministry of Finance's Public Debt Department; and enhance the primary and secondary market for government securities.

18. **Further improvements in economic statistics will support the quality of policy formation and economic monitoring.** Substantial progress in improving data quality and coverage—particularly for budget revenues and expenditures—led to Jordan's subscription to the Fund's Special Data Dissemination Standard (SDDS) in January 2010. The mission welcomes the finalization of SDDS subscription, as well as recent revisions to the historical balance of payments statistics (2000-08) which better account for the trend increase in errors and omissions. The mission supports the authorities' plans to seek follow-up technical assistance on improvements to its balance of payments statistics. Going forward, further enhancements in the frequency and timeliness of expenditure-based national accounts data, and in the quality of high-frequency production-based national accounts, would assist policy formulation. The development of regular and timely wage, employment and real estate statistics would also enhance monitoring of labor and asset markets.