Jordan—2009 Article IV Consultation Concluding Statement of the IMF Mission

March 8, 2009

Jordan's limited integration with global financial markets has buffered it from recent turmoil. At the same time, strong trade links with the region and rest of the world, which have underpinned robust economic growth in recent years, imply that the global economic downturn will affect the domestic economy. Managing the prospective slowdown is the key near-term challenge.

1. Jordan's macroeconomic performance was generally favorable in 2008. Real GDP growth averaged over 6 percent in the first three quarters, only slightly slower than the 2007 pace. After climbing sharply due to the surge in world fuel and food prices, inflation subsequently came down quickly as commodity prices softened. Lower world commodity prices also helped narrow the current account deficit to an estimated 12¾ percent of GDP in 2008 (from 17 percent in 2007). Official foreign exchange reserves rose to $7.7 billion by end-2008 (equivalent to 5½ months of imports).

2. Economic activity is expected to slow significantly in 2009, reflecting the much weaker global and regional outlook. Real GDP growth is projected to ease to 3-4 percent. Inflation will likely continue to moderate to an average of about 4 percent over the year, aided by soft world food and fuel prices. Exports are projected to decline because of weaker external demand as well as lower mining export prices. The impact on the current account, however, will be more than offset by lower imports. As a result, the current account deficit is projected to narrow further to about 11¼ percent of GDP. With risks to the global economy tilted to the downside, Jordan's macroeconomic policies should remain focused on reducing external and fiscal vulnerabilities.

3. The budgeted fiscal stance for 2009 strikes a reasonable balance between reducing vulnerabilities and supporting domestic activity. Based on the latest developments and macroeconomic assumptions, the fiscal deficit is projected at a little above JD 800 million (about 5.3 percent of GDP). Although the decline in world commodity prices will

result in significant savings in the cost of subsidies and transfers, this will be more than offset by weaker revenue on account of lower inflation and slower GDP growth. The consequent widening of the deficit in relation to the budget—by 0.8 percentage point of GDP—should be seen as moderate stimulus that will help support activity without unduly exacerbating macroeconomic imbalances. The projections assume that foreign grants will remain relatively high (4.5 percent of GDP). Clearly, a shortfall in grants will heighten fiscal and external vulnerabilities.

4. Further fiscal stimulus—beyond that contained in the updated baseline budget outlook—would carry significant risks. Since Jordan is a highly open economy, a large share of any additional spending will be associated with increased imports. This will dampen the stimulative impact on domestic activity and, at the same time, widen the external deficit and associated vulnerabilities. Moreover, with capital spending already set to increase by over 35 percent in the baseline, the efficiency of an even larger increase would be difficult to maintain. If further stimulus is nevertheless undertaken, it will be critical to ensure that additional spending is temporary and carefully targeted. In such circumstances, announcement of a credible plan to reduce the fiscal deficit over the medium term will be needed to maintain confidence in the sustainability of fiscal policy and the external position.

5. Once cyclical conditions improve, a significant tightening of fiscal policy is needed to reduce public debt and the associated fiscal and external vulnerabilities. Given the already high revenue ratio, the adjustment should concentrate on the expenditure side. The mission recommends reducing the overall deficit by about 1 percentage point of GDP a year. This can be accomplished by limiting the growth of recurrent spending—especially wages and pensions—supported by much-needed pension and civil service reforms. In the absence of such adjustment, the public debt ratio will likely exceed the medium-term public debt ceiling of 60 percent. If additional fiscal stimulus is undertaken in 2009, the necessary medium-term fiscal adjustment will be correspondingly larger.

6. Moderate monetary policy easing may now be appropriate. In recent months, the CBJ has taken pre-emptive steps to maintain confidence and support the domestic money market. These include a full guarantee of all bank deposits, cessation of liquidity operations, and cuts in policy interest rates and reserve requirements. In addition, confidence in the peg has helped maintain a strong balance of payments position at a time of unusual turbulence in global financial markets. With reserves continuing to build, inflation firmly on a downward path, bank credit slowing sharply, and a widening interest differential with foreign rates, there now appears to be room for cautious easing of the monetary stance. A gradual lowering of policy rates and reserve requirements would help support economic activity and soften the impact of the global slowdown on the domestic economy. Of course, monetary policy should

remain attuned to external developments, especially in these turbulent times. Close monitoring of the Central Bank of Jordan's (CBJ) key external and financial early warning indicators will be necessary, and the CBJ will need to stand ready to tighten quickly—possibly by resuming CD issuance—if signs of balance of payments pressure emerge.

7. The exchange rate peg, which has provided stability in the challenging global environment, remains an appropriate nominal anchor. The mission's analysis of the real exchange rate suggests that the dinar remains broadly aligned with medium-term fundamentals. The risk of external instability from the capital account is mitigated by the fact that external debt is almost entirely to official creditors and reserves are comfortable in relation to short-term liabilities, although the sharp increase in errors and omissions in the first half of 2008 is a concern.

8. Banking sector profitability and soundness indicators are generally favorable, but the weaker global environment poses significant risks. Stress tests conducted by the recent FSAP Update indicate limited exposure to interest rate, liquidity, interbank contagion, and other market risks. However, the tests also identify vulnerability to credit and concentration risk. In particular, the real estate, construction, and foreign trade sectors are vulnerable to weaker activity, and banks with substantial exposures abroad will also be adversely affected by the slowdown in advanced economies. Encouragingly, banks have been repricing credits, closely monitoring exposures, and building capital buffers to reflect the heightened risks in their portfolios.

9. Intensified banking supervision is warranted in the current environment. The FSAP Update identified a number of areas that would strengthen the financial system. These include strengthening capital adequacy of banks close to the regulatory minimum, enhancing consolidated supervision, and developing the contingency planning framework. The mission welcomes the measures taken by the CBJ to enhance banking supervision, the capital buffers in the banks, and its early warning systems, and the CBJ's indication that it will take further measures if necessary to ensure banking soundness and stability. The mission encourages the authorities to intensify their contingency planning to deal with worst-case situations, including delineation of responsibilities and coordination between the CBJ, the Ministry of Finance, and the Deposit Insurance Corporation. The mission also recommends recapitalizing the CBJ over the medium term.

10. Continued progress in public sector structural reforms will enhance prospects for private sector led growth. In the public financial management area, top priority should be accorded to tackling outstanding reforms, especially implementing fully the treasury single account; improving budget classification and control; rolling out the GFMIS; and continuing to strengthen the medium-term framework for budget formulation and

preparation. The mission welcomes continued efforts to enhance public debt management, which is expected to be supported by follow-up technical assistance from the Fund in June.

11. The mission urges expeditious progress in resolving data issues. Priority should be given to the remaining requirements for SDDS subscription—improving the compilation and coverage of wages and earnings data, and aligning the coverage of budget revenues and expenditures with government financing flows. Progress is needed in identifying any gaps in the coverage of balance of payments statistics that could explain the sharp increase in errors and omissions in 2008. A better understanding of these flows is critical for policy making. Further improvements in the quality of quarterly production-based national accounts statistics as well as the frequency and timeliness of expenditure-based national accounts data would also aid policy formulation.