Annex 3 Review of the IMF Staff's Debt Sustainability Analyses and Their Input into Program Design

The review is based on the four major examples of debt sustainability analysis undertaken for Jordan since 2002: (1) the February 2002 internal briefing paper on the medium-term fiscal strategy, part (but not all) of which was reproduced (as Annex II) in the subsequent staff report on the 2002 Article IV and review of the EFF; (2) the debt sustainability analyses prepared in mid-2003 at the time of the first review of the 2002 SBA (Annex II of IMF, 2003b); (3) the discussions of external and fiscal debt dynamics prepared for the 2004 Article IV (Chapters IV and V of IMF, 2004a); and (4) the debt sustainability analysis prepared as part of the post-program monitoring discussions (IMF, 2004b).

The conclusions are as follows. First, these sustainability analyses did pay increasing attention to the issue of what would be an appropriate longer-term debt target for Jordan. For example, the background papers for the 2004 Article IV consultation contained a comprehensive assessment drawing on a mix of quantitative indicators, analysis of debt dynamics, and cross-country comparisons. It concluded that Jordan has a relatively high degree of liquidity compared to developing countries as a whole and most subgroups (in terms of debt service on a cash basis and external reserves) and that the future paths of external adjustment and fiscal consolidation were, to a considerable extent, policy choices rather than been driven by exogenous financing constraints as in earlier years. However, it also noted that, from a stock perspective, external debt was still large in relation to GDP by virtually any cross-country comparison; for example, debt in relation to the size of the economy or exports of goods and services was still generally on par with that of heavily indebted lower-income countries.[1] While the stock of debt was not judged to be a problem in a solvency sense, the assessment concluded that, even after over a decade of declining debt ratios, the image of a debt overhang was still an issue. While notions of the appropriate long-term levels of external and public debt are inevitably very imprecise, the staff did undertake an insightful analysis of what the authorities' macroeconomic framework would imply for various deficit and debt measures through 2008, compared with the average current level of those variables for countries with an investment grade credit rating.[2] The conclusion was that maintenance of the authorities' then-targeted adjustment path would lead projected fiscal outturns and public sector net external debt to outperform the average "BBB" rating and, hence, would contribute significantly to a possible achievement of investment grade status, with positive consequences for market confidence and, ultimately, for growth.

Second, while there was relatively little analysis in early program documents of the consequences for growth of different paths for external and fiscal adjustment, IMF staff have made greater attempts to assess potential trade-offs more recently. The rationale for fiscal consolidations under all of the programs was to contribute significantly to the achievement of external objectives and to growth by boosting domestic savings and creating room for private credit and investment. However, the underlying analysis in earlier programs typically did not go beyond this broad qualitative rationale. For example, until the 1999 EFF, there was very little discussion of conditions under which fiscal policy could be deployed to play a countercyclical role. The 2002 medium-term fiscal strategy paper represented a significant and welcome turning point in this regard, since it explored (1) the potential consequences of debt reduction for domestic investment and hence

[1]For example, the net present value (NPV) of the debt to exports ratio was estimated to be in excess of 200 percent at end-2003—higher than the threshold 150 percent NPV of debt to exports targeted under the Heavily Indebted Poor Countries exercise.

[2]The comparison was with countries that had a "BBB" sovereign rating (the second lowest investment grade) from Standard & Poor's (S&P). See Chapter VII of the background paper (IMF, 2004a) to the 2004 Article IV consultation. Jordan's sovereign credit rating by S&P at the time was "BB," the second highest "speculative" grade.

growth;[3] (2) trade-offs between the potential future impact of fiscal adjustment on improving longer-term growth prospects and the shorter-term consequences for growth;[4] and (3) an analysis of the potential macroeconomic effects of the Plan for Social and Economic Transformation (PSET) which was launched in November 2001.

Finally, given the historical importance of grants in the Jordanian economy, their treatment in program design—and the sustainability analyses that underlie the IMF's macroeconomic policy advice—is a critical issue. Following the initial sharp drop in grants during 1989–91, programs have incorporated fairly cautious projections for grants. They were generally assumed to decline gradually, and actual outcomes were usually higher than program projections—albeit only moderately so until the recent upsurge in grants in 2003–04. The 2002 internal fiscal strategy paper concluded that, given the fact that grants had remained fairly stable over the previous decade, it would be appropriate to shift to formulating fiscal targets including grants.[5] Ironically, this shift took place just before grants became, once again, potentially highly volatile. More fundamentally, recent assessments tended to underplay the potential vulnerabilities posed by the recent upsurge in grants and matching boom in government expenditures. While the assessments contained in the Board papers rightly emphasized that the grants should not be used to finance a permanent pick up in expenditures, they implicitly assumed that the subsequent adjustment to a drop-off in grants would be relatively smooth. For example, the two assessments undertaken in 2004 consider the consequence of a variety of shocks (to the exchange rate, interest rates, real GDP) and conclude that the external debt burden would remain manageable under all but the most severe shocks (with the most worrisome scenario judged to be a large exchange rate shock). But these assessments say relatively little about the potential dangers involved in managing a sharp reversal of grants or about policies that could help smooth the macroeconomic consequences. The discussion in internal staff notes tended to be somewhat franker about the potential risks.

This analysis of potential trade-offs between different strategies for restoring stability did result in a significant shift in program design. The 1999 EFF had targeted an ambitious fiscal consolidation effort (a reduction in the overall fiscal deficit, before grants, equivalent to over 5 percent of GDP during the three-year program period)—an objective that was not achieved as fiscal targets were missed repeatedly. The EFF also underemphasized the impact of "below the line" debt reduction operations which, in the event, helped to reduce Jordan's public debt significantly despite the fiscal slippages. Consequently, the 2002 strategy brief concluded that the fiscal strategy underlying the 1999 EFF needed substantial modification and recommended a revised approach to addressing the debt problem that emphasized (1) a more gradual contribution from "above the line" revenue/expenditure measures—less ambitious in quantitative terms but focusing on wide-ranging reforms in the areas of tax policy and administration and of expenditure policies to address key rigidities that were driving the rapid trend growth in many expenditure categories; and (2) more aggressive efforts to reduce debt through debt restructuring/reduction operations and the use of privatization proceeds. Much of this strategy was subsequently adopted in the 2002 SBA.[6] However, the Board paper that presented the program under the new SBA was less forthcoming than the internal briefs on the rationale behind the change in approach.

[3]An illustrative quantitative exercise indicated that a reduction in Jordan's pre-cutoff date bilateral official debt by 50 percent in NPV terms could increase domestic investment by 1–2 percentage points of GDP—by easing the impact of the "debt overhang" on private investment and by creating room for higher public and social capital outlays.

[4]The basic conclusion was that exclusive focus on (short-term) fiscal adjustment could undermine the objective of higher economic growth and alleviation of poverty, at least initially, and that establishing implicit quantitative limits on expenditure growth could be frustrated if the underlying structural factors (e.g., various revenue and expenditure rigidities) were not adequately factored into the medium-term fiscal targets, along with the necessary fundamental policy changes to address them.

[5]The paper referred to an approach that measured fiscal performance in terms of the deficit excluding grants as "prudent but impractical" for a country in Jordan's circumstances (i.e., where grants were likely to be sizable for the foreseeable future and where they had "remained fairly stable"). Reflecting this judgment, the key fiscal performance criteria under the 2002 SBA shifted to a ceiling on the overall deficit after grants, in contrast to a ceiling on the deficit before grants under the 1999 EFF.

[6]In the event, the massive surge in grants that occurred in 2003–04—and the associated pick up in government expenditures—caused the fiscal deficit before grants to increase substantially even though the fiscal performance criteria under the 2002 SBA (the deficit after grants) were met.