Economic Outlook-Hanging in the Balance

Introduction

According to the International Monetary Fund (IMF) the world economy is expected to expand by 3.5% in 2013. Emerging markets such as China are expected to lead the growth outturn, while the US should continue to grow at a moderate pace. The dark clouds that hung the European Union (EU) should begin to show signs of dissipating this year, as the European Central Bank's (ECB) bond repurchases in 2012 helped to reinstate well needed liquidity back into the financial system, stemmed the slide of the euro and improved confidence in the economy. However the EuroZone is still not out of the woods as another member state, France, is nearing the brink of a crisis. The IMF estimates that the 17-country euro area is expected to shrink by 0.2% in 2013, marking the second year of recession.

Locally, the air of uncertainty surrounding the IMF deal has caused businesses and consumers to restrict spending as the country braces itself for the possibility of the "bitter medicine" that could follow the inking of a new deal. These sentiments have been reaffirmed by the decline in the business confidence index. While the consumer confidence index was unchanged, consumers have cut back on their spending plans for this year. Such caution implies an underlying degree of uncertainty about prospects for the overall economy and about the direction of government policy. Jamaica's growth trajectory continues to be undermined by high levels of unemployment, declining business confidence and a slowdown in growth of the economies of its major trading partners. During the fiscal year, weakness in consumer spending was further compounded by tax measures imposed by the government. More recently, the economy was dealt a further blow with the passage of Hurricane Sandy which resulted in significant damages to the island's infrastructure. In addition, depreciation of the local currency particularly in the September quarter has raised concerns about the sustainability of the low interest rate and inflation environment. Given the deterioration in economic conditions, there has been growing market uncertainty. The inability of the Government to secure an IMF agreement has contributed to the market jitters. Recently, Minister of Finance sought to provide an update on the progress of the negotiations with the IMF, in light of the fact that the self-imposed year-end deadline to secure a deal expired. According to the minister, talks with the Fund's technical staff have almost ended, with the focus now being on the timetable for a comprehensive policy on tax waivers and incentives. Although a new timeline was not provided, we expect that a deal will eventually be brokered. However the government will have to show continued commitment to meeting long standing fiscal consolidation measures such as public sector rationalization and pension reform.

The International Market

The US economy grew at an annualized pace of 3.1% in the third quarter up from 1.3% in the second quarter. It is expected that fourth quarter GDP results will be negatively affected by the effects of Hurricane Sandy and weakened consumer confidence during the "fiscal cliff" negotiations. As such, GDP is expected to be within the range of the US Federal Reserve projected growth of 2.2% - 2.7%. Although moderate, the US economy has enjoyed more than three years of uninterrupted economic growth and falling unemployment since the recession ended. The unemployment rate in December held firm at 7.8%, after the November figure was revised up from a previously reported 7.7%. Unemployment is still at its lowest level since 2008. Other reports have indicated that the service industries, which account for almost 90% of the economy, grew in December at the fastest pace in 10 months, and demand for capital equipment such as machinery and communications gear picked up in November.

The deal brokered following the 'fiscal cliff discussions made permanent the Bush administration's tax cuts for individuals earning less than $400,000 per year and couples earning less than $450,000. The middle class is considered to be the lifeline of the American economy, and as such the tax cuts should continue to bode well for economic recovery. Meanwhile, earners in the higher income bracket will feel the pinch from higher taxes, which move from 35% to 39.6%. It is estimated that this will raise roughly $600Bn in new revenues over 10 years. New headwinds are expected in 2013 as the US has reached its legal borrowing limit of $16.39Tn.. The debt limit is

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the total amount of money that the US government is authorized to borrow to meet its existing legal obligations as it does not authorize new spending commitments. While meetings to raise the debt ceiling is ongoing, a resolution is not likely to be quick in coming, as Democrats and Republicans have largely disagreed over spending cuts and new initiatives to be undertaken under the current administration. Delays in reaching an agreement could result in another downgrade by credit ratings agencies. Unless a quick resolution to the debt situation is reached, a situation similar to events which unfolded prior to the debt ceiling being raised in 2011, which saw financial markets posting several days of sharp losses, could recur.

The Eurozone contracted by 0.1% in the third quarter of 2012 after a decline of 0.2% in the previous quarter. The unfavourable results confirmed that the 17-nation currency area was back in recession for the first time since 2009. Continued efforts by governments and households to reduce debt, rising unemployment and uncertainty over the fate of weaker members have depressed the zone's economic activity. Germany and Netherlands both registered marginal growth of 0.2% and 0.1%. Also of concern is the sluggish economic activity in France. The French economy, Europe's second largest, grew at an estimated 0.1% in 2012, and unemployment remains at a 14-year high of nearly 11%. Greece came under immense pressure during the year as some policy makers believed that the country should have been removed from the EU to preserve the integrity of the Euro. However the European Central Bank President reaffirmed its commitment to doing whatever it takes to preserve the euro, by intervening in bond market.

In 2013, the ECB's bond repurchases last year should help to reinstate well needed liquidity back into the financial system, stemming the slide of the euro, leading to improved confidence in the economy. Lending rates are expected to remain at a record low during the year and the ECB has noted that it would continue to offer unlimited loans to banks at least through the middle of 2013. Despite the monetary easing, the effects of its restrictive fiscal policy will continue to weigh on economic growth. The IMF expects that the 17-country euro area will shrink 0.2% in 2013, marking the second year of recession. The IMF foresees Spain leading the contraction in the euro area, while growth slows in Germany, the region's largest economy. European officials still face unemployment at a record 11.8% in the euro area. The region's outlook is expected to improve, with the Fund forecasting a return to growth of 1% in 2014.

According to the IMF, the Chinese economy is expected to grow by 8.2% this year and 8.5% in 2014, as the country continues to employ expansionary policy tools. China's manufacturing sector expanded in December at its fastest pace in 14 months as new orders and employment rose, adding to evidence of a pick-up in the economy. According to official data from the National Bureau of Statistics, China's industrial production rose by 10.1%. At the same time, retail sales increased by 14.9% as consumer sentiments were lifted by renewed confidence in the economy. Both are positive signs that the economy is on the rebound, and growth is gathering pace after nine consecutive quarters of decline.

Local Economy

Following a decline of 0.2% in the second quarter, Statin reported that local economy contracted by 0.2% for the third quarter of 2012 when compared to the corresponding 2011 period. This was primarily due to a 1.8% decline in the Goods Producing industry, which completely offset the 0.3% increase in the Services industry. The decline in the Goods Producing industry resulted from lower output levels in Mining & Quarrying and Construction industries which fell by 11.1% and 2.9% respectively. The Agriculture, Forestry & Fishing and Manufacture industries however experienced growth of 0.2% and 0.3% respectively.

The International Monetary Fund (IMF) predicted that the Jamaican economy would grow by 0.9% for the 2012 calendar year, a significant reduction from its prior estimate of 1.7%. However, given the slowdown in the economy, economic activity is expected to significantly depart from the IMF's trajectory. Continued fallout in the construction sector following the stalling of the JDIP program is also expected. Any closure of the Windalco plant

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due to the current glut in the supply of alumina production and lower global demand should continue to depress the Mining and Quarrying sector. Further, indications that economic activity will slow in 2013 comes as business confidence in the last quarter of 2012 fell to near its lowest level in the last four years. Uncertainty surrounding an IMF deal continues to weigh on confidence, causing businesses to delay hiring and investment decisions. The index of Business Confidence was 92.3 in the Q4 2012 survey, down from 106.3 in Q3. Uncertainty about evolving fiscal and monetary polices in response to IMF negotiations as well as concerns about domestic demand and the strength of the economies of Jamaica's main trading partners acted to diminish optimism. That being said, the longer it takes for a deal to be brokered and the conditionalities revealed, the more likely it is that economy will contract further as investment and consumption expenditure decline. Expectations of lower consumer spending are affirmed by the fact the survey revealed that purchases for 2013 are expected to decline as consumers shelve spending plans.

Fiscal and Debt Dynamics

For the fiscal year to November, Central Government recorded a fiscal deficit of $48.27Bn which exceeded the budgeted amount by $2.07Bn. The primary surplus was $31.30Bn or $6.11Bn less than budgeted. This brings the primary surplus to GDP to 2.5%[1].The primary balance is of concern as it is increasingly likely that the government will have to increase taxes, in addition to spending cuts, in order to get to its targeted figure of 7.3% by fiscal year 2014/2015. The outturn of the fiscal balance for the period reflected lower revenues and grants which amounted to $210.66Bn and represents a $10.32Bn shortfall. Revenues from International Trade underperformed as income from Custom Duty, GCT on Imports and SCT on Imports all recorded shortfalls. Receipts from Income and Profit also fell below target primarily due to lower PAYE receipts. It is expected that receipts from PAYE could deteriorate in the upcoming months given the trajectory for higher unemployment levels. On the other hand, income from Production and Consumption were bolstered by receipts from SCT and Stamp Duty (Local) as both line items were above budget by $705.5Mn and $489.7Mn, respectively.

It is unlikely that the government will meet its primary surplus balance to GDP target of 6.5% this fiscal year given the underperformance of tax revenues and the fact that year to date the primary balance to GDP is approximately 2.5%.[2] In order to get to the targeted level the primary surplus would have to increase by approximately $49,346Mn for the remainder of the fiscal year. That said, in order to bridge the gap, it is possible the taxes will be increased.

The country's continued high trade imbalances and weak fiscal picture have magnified the country's debt exposure. The current debt to GDP ratio now stands at 128%. This is a source of concern given that the sovereign's financing needs will likely continue to remain large in FY2013 driven by increasing domestic amortizations and the start of repayments to the IMF. As at September 2012, foreign debt accounted for 43% of the country's total debt stock, and is concerning given the rapid pace of J$ depreciation and the exposure to currency risks. Given the outlook for further depreciation of the local currency, the country's debt position will likely worsen. While the government is expected to employ more restrictive policy measures in order to bring the debt to sustainable levels, this will be at the risk to economic growth. The significant proportion of revenues used to service the debt has meant that very little is left for the government to spend on infrastructural development. Roughly 48% of tax revenue is spent on making interest payments. Further, 75% is used to service debt and pay wages which underscores the country's limited fiscal flexibility.

Based on the current dynamics, credit ratings agency Fitch, revised Jamaica's ratings outlook from stable to negative. Fitch's outlook revision was also prompted by the fact that the government's FX financing remains limited, as multilateral disbursements and access to international disbursement is constrained by the absence of an IMF agreement.

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[1] The Nominal GDP as at 2011 was used.

[2] Primary balance to GDP, estimated using nominal GDP figure as at FY2012

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In a statement released at the end of the year, the Minister of Finance sought to provide an update regarding the negotiations with the IMF. The statement came in light of the fact that the year-end deadline he had communicated for the finalization of a deal with the Fund had already expired. The Minister indicated that discussions with the Fund were centered on the challenges of halting the debt accumulation process, raising economic efficiency in both the private and public sectors and creating the conditions for self-sustaining growth. He indicated that there has been extensive exploration of the size, range and scope of the public sector and all the elements that contribute to the persistent fiscal deficits. These include, tax policy, staff costs, interest costs, capital expenditure (prioritization, partnership, divestment); and how best to protect the most vulnerable. Additionally, in a press briefing held on January 14, 2013 Dr. Phillips disclosed that the Cabinet unanimously signed off on measures required to advance the negotiations and reach satisfactory agreement with the IMF.

Inflationary Pressures to Increase

Fiscal, calendar year-to-date and 12 month point to point inflation as at November 30, 2012 was 5.2%, 6.9% and 7.4% respectively, compared to the 5.1%, 5.6% and 7.1% reported for the corresponding 2011 period. This performance was greatly affected by tax measures implemented in the FY2012/13 budget which included the widening of the basket of taxable goods to include items that were previously tax-exempt. The "Food and Non-Alcoholic Beverages" division, the most heavily weighted category in the index, continues to be the leading driver in inflation growth, reporting a point to point increase of 12.6% as at November 30. The recent passage of Hurricane Sandy impacted agricultural supply which translated into higher prices to consumers. Higher grain and wheat prices brought on by drought conditions in the US also triggered increases in food prices. This was further compounded by the continued depreciation of the local currency which has led to higher prices on imported goods as well as the "Clothing and Footwear" division which reported the second largest movement over the last 12 months. The impact of these occurrences, however, was somewhat tempered by weak local demand and the slow movement in imports and key commodity prices such as oil. The moderation in oil prices tempered inflationary pressures in the second largest index, "Housing, Water, Electricity, Gas and Other Fuels", which slowed from 11.0% to 6.3%. The significant reduction in calling rates by mobile providers also resulted in lower costs across the "Communication" division, thus easing inflationary impulses. Given the year to date outturn, it is likely that inflation will fall within the BOJ's 10.0% to 12.0% forecast for the FY 2012/13.

Inflationary pressures are likely to increase in subsequent periods given the rapid depreciation of the currency, the continued upward movement in oil prices and possible increases in food prices as a result of the current drought. Further, indications from the Minister of Finance that there could be additional tax measures to assist in closing the gap in the fiscal accounts could put upward pressure on consumer prices.

Foreign Exchange Market

For the 2012 calendar year the local currency depreciated by 7.4%. Earlier in the year US$ inflows slowed with the closing of the winter season. Additionally, Net Remittances for the month of October 2012 were US$141.8Mn which was US$1.9Mn (or 1.3%) less than last year's. The decline in net remittances was primarily due to the falloff in remittance inflows from all source countries except Canada. In the UK, high unemployment levels and the weak economic conditions will continue to reduce the ability of individuals to remit funds to Jamaica. Also, US residents were still grappling with the effects of Hurricane Sandy and remained cautious due to the uncertainty of the Fiscal Cliff agreement at the time. In spite of the shortfall in the monthly net remittances, year to date (January – October) net remittances were up by just 0.7% to US$1,462.6Mn which was predominantly on account of robust remittance inflows in the first half of 2012. Nevertheless, it is anticipated that positive movements in the US unemployment rates during the holiday season along with additional demand for skilled workers during the reconstruction phase in the aftermath of Hurricane Sandy should have positively impacted remittance inflows this year.

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Net International Reserves for December stood at US$1,125.58Mn of 13.21weeks of imports, and represented a US$47Mn increase over the previous month. Though reserves remain above the critical point of 12 weeks of imports of goods and services, reserves are still dangerously close to the benchmark. As such the BOJ remains restricted in its ability to intervene in foreign exchange market. The protracted delay in having an IMF agreement in place will continue to put pressure on the currency which could result in further depreciation. In the absence of an agreement and the inability to tap into inflows from multilaterals, we expect further depreciation. The current economic uncertainty will likely restrict foreign direct investments (FDI), while the significant gap in the trade account will add further FX pressures. The pace of depreciation will likely be compounded by continued portfolio switching, unless an IMF deal is brokered. A deal would provide balance of payments support, helping to stem the decline of the J$.

Interest Rates Remain Steady

Interest rates have remained fairly stable since the start of the year. The BOJ maintained the 30-day CD as its only OMO instrument and that rate held steady at 6.25% for the entire year. The December Treasury Bill auction resulted in a weighted average yield on 30-day Treasury bill yield of 6.31%, being the highest 30 day yield outturn since March. Notably, the yields on the 90-day instrument increased by 129 basis points (1.29%) to 7.67% while the 180-day yield moved up by 37 basis points to 7.18%.

JMD liquidity levels remained suppressed over the last few months. The tight JMD liquidity condition is expected to persist in the short term especially with only moderate OMO inflows expected. Brokers continue to have a strong demand for longer tenured funds. On the other hand, high liquidity levels continue to be observed in the USD market. Currently, interest continues to be expressed for tenures along the longer end of the curve, however, at reduced rates. With no sign of demand for the greenback abating and a very inactive USD primary market, liquidity levels are expected to remain high in the short term.

The depreciation in the local currency following increased US$ demand and rising food prices could pose a threat to inflation. However, we do not expect BOJ to raise its benchmark rates, given the clear stance as it relates to maintaining low interest rates. At the same time, it is unlikely that the BOJ will lower its benchmark interest rate without an IMF agreement in place given the likely pressures this could put on the local currency.

Outlook

The U.S. economy is expected to grow by 2.5% in 2013, improving to 3.5% growth in 2014, based on pronouncements by the Feds. However the IMF has predicted a lower rate of 2.1% in 2013. The Fed forecast U.S. unemployment rate would be 7.4% this year, down from its current level of 7.9% as the job market continues to show strength. In Europe, policy makers are declaring they have gained the upper hand in the three-year-old debt crisis and are sharpening efforts to channel a rebound in financial markets. President Draghi's pledge to do whatever it takes to deliver the 17-member currency out of the crisis has been credited for declining yields and an easing in market turmoil. This is expected to give leaders more room to grapple with issues such as unemployment in Europe.

Locally, we expect that a deal will be brokered between the government and the IMF, however the government will have to show continued commitment to meet long standing issues such as public sector rationalization. The likely sticking points that have hindered the signing of a deal, relate to the negative repercussions of the policy and conditionalities on the Jamaican economy. The contractionary effect of the likely austerity measures in the absence proper social safety net could increase the vulnerability of many persons. Within this context, the Minister has indicated that deliberations to overcome differences of view on appropriate measures, impact, and significance constituted a significant portion of its negotiations. In the meantime, the economy continues to hang in the balance, with continued declines in GOJ bond prices, low market activity and further depreciation of the local currency.

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Disclosure

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