FISCAL ADJUSTMENT AND THE PROSPECTS FOR GROWING OUT OF DEBT IN JAMAICA

Outline

1. **Introduction**

Jamaica is one of the most heavily indebted countries in the world. Its external debt doubled in the late 1970s and again in the first half of the 1980s. In the 1980s, the external debt was already a problem as Jamaica engaged several annual Paris Club rescheduling of its bilateral debt. After the shock of precipitate full liberalization of its foreign exchange system, Jamaica managed to stabilize its fiscal performance and generated a ratio of public debt to GDP of significantly below 100%. These improvements were undone by the financial sector crisis and the terms on which it was resolved. The recapitalization of failed institutions with the guarantee of full restitution to depositors cost some J$140 billion and pushed the the ratio of debt to GDP to over 140%.

The weight of such a debt burden implies significant pre-emption of fiscal resources for debt servicing. To correct the problem without formal rescheduling or default, requires the generation of primary fiscal surpluses of 10% or more. This implies limited fiscal resources for essential services in education, health and national security, as well as for public sector non-debt capital expenditure to underpin economic growth. It also implies limited flexibility and over-optimism in budgeting, and extreme fiscal vulnerability to exogenous shock.

For the past decade, Jamaica has been attempting to adjust its way out of its debt problem. This has entailed setting medium term targets for the elimination of the fiscal deficit, requiring the generation of double digit primary surpluses. These medium term targets have been met mostly in the breach and have had to be recast on several occasions. Despite these deviations, there has been significant effort reflected in large primary surpluses, resulting in some moderation in resource pre-emption for debt servicing to Fiscal Year 2006-07. The Debt/GDP ratio fell slowly to about 125%of GDP by 2007/08 and with a subsequent revision to nominal GDP to about 108% for that year.

It has remained true, however, that overruns on recurrent expenditure , have been partly corrected for by contractions in capital expenditure, including counterpart financing for externally financed projects. This has contributed to the continued weakness in economic growth, leaving adjustments in nominal GDP to be dependent on inflation. The increased importance of external debt however, and in the context of a flexible exchange rate system, reduces the efficacy of inflation in reducing the debt burden.

Following the change in political administration in the middle of Fiscal Year 2007/08 the dynamics of the interaction between fiscal performance and debt management have not improved . Fiscal flexibility continues to be limited, budgets continue to be overoptimistic and there is ongoing susceptibility to exogenous shocks.

While there have been weather related factors, the major economic shock has come from the international financial market and economic crisis, as it unfolded from the last quarter of 2008. Elements of Jamaica's financial sector have been exposed to margin calls on holdings of sub-prime external assets eliciting the commitment of official external reserves by the Central Bank. Foreign exchange inflows from remittances, tourism and bauxite/alumina exports were severely affected, private capital inflows have declined sharply, and with indications of increased foreign exchange outflows, the foreign exchange market experienced excess demand in late 2008.The rate of inflation increased in late 2008 but moderated in 2009. With the severe decline in export earnings, the economy continued to stagnate.

Despite being put on watch for debt rating downgrades from late 2008, fiscal adjustment was delayed and what is now seen as an overoptimistic budget was tabled for 2009/10. Within the first quarter of the fiscal year, it was apparent that revenue estimates were overoptimistic and that weak exports and private capital inflows created the likelihood of a sharp diminution of foreign exchange reserves in the course of the year. By the end of that quarter, the Government admitted to exploratory talks with the IMF and indicated in July that it expected to have a new borrowing agreement by August. In the context of continuing talks with the IMF, Supplementary estimates were tabled in September 2009.

The Government of Jamaica expects to get substantial foreign exchange inflows from the IMF (as Balance of Payments support, where the borrowing agreement will also be catalytic to budgetary support from other multilateral financial institutions. It is expected that this multilateral funding will be on more generous terms than that afforded by international financial markets. At issue though, is whether the IMF, through the borrowing agreement being negotiated, being expected to guarantee that Jamaica will be in a position to service its debt.

The supplementary estimates, largely in recognition of errors in the original estimates, reflect a widening of the fiscal deficit by some three percentage points of GDP. This does not enhance the medium term debt profile. Accordingly, the capacity to repay has to be guaranteed by the budget for the next and subsequent financial years. This capacity to repay is co-dependent on the capacity to adjust and the capacity to reallocate resources to facilitate growth.

Against this background, the paper seeks to explore the relationships among fiscal deficits, public debt, fiscal adjustment and economic growth in Jamaica. Regarding adjustment, it will look at the impact of IMF programmes on economic growth. The paper will examine the recent evolution of Jamaica's fiscal and debt problem and critically examine, from the current juncture, its prospects for adjusting and growing out of debt.

It will conclude that the options for adjustment are severely limited especially if the budget has to be reoriented to resource allocation for stronger growth. Such adjustment may entail severe social welfare losses in the short run and will demand significant political courage and constructive cooperation between the various stakeholders in society.

2. Perspectives on the Impact of Fiscal Deficits and Public Debt on Economic Growth

Neo-classical economic theory tends to prescribe a limited role for Government in facilitating economic activity and economic growth. From axioms of rationality and assumptions underpinning perfect markets, economies are expected to tend towards Pareto Optimality in General Equilibrium. As a first approximation, the role of Government is limited to regulating markets against the intrusion of market imperfections, the protection of property rights through the judicial process and the establishment of civil order and national security. The role of Government is then embellished through a recognition of the reality of public goods, externalities and natural monopoly as evidence of market failure.

Solow's exogenous neo-classical growth theory also implied a limited role for Government in the facilitation of economic growth. Long term steady state growth is driven largely by the rate of population growth, with allowance being made for depreciation of the capital stock. Incremental growth could only derive from technological change. This technological change is exogenous to the model, defining no clear role for Government in enhancing economic growth. The exogenous growth model yields the result that from a perspective of intergenerational optimality, the long run tax rate on capital income should be zero.

The shortcomings of exogenous growth are addressed through endogenous growth models. These explicitly model the process through which growth is generated. Investment is in either human or physical capital, and technical progress may be embodied in the quality of either form of capital. New efficiency enhancing inputs can enter the production process counteracting the tendency to diminishing returns to per capita capital input. A special case is a public good input that allows for constant returns to private capital per head. These inputs may include bureaucratic and regulatory efficiency, education and support for research and development.

The economic performance of industrial market economies from the last quarter of the 19th Century and the first quarter of the 20th century was consistent with the neo-classical perspective on minimalist Government. The Great Depression and the impact of the Second World War (1939-45) established the credentials of Keynesian public policy intervention to pursue full employment without inflation. Fiscal deficits came to be accepted as means of avoiding the wasteful underemployment of economic resources and to facilitate economic growth.

The emergence of Development Economics, in the context of decolonization, also highlighted the importance of public policy in facilitating economic transformation and economic growth. Flowing from a statistical recognition of significant differences in living standards between developed and underdeveloped countries, there evolved several approaches to the problem of economic transformation. These included "big push", "stages of growth" and variations of "centre-periphery' and "structural" models.

From the 1950s, several ex-colonial countries achieved independence in this context of an acceptance of Government responsibility for economic welfare, economic growth and economic transformation. This acceptance manifested itself variously in government borrowing to finance infrastructural projects, substantial public sector employment and generous tax incentives to stimulate investment in new exports and in import substitution.

The perspective of activist fiscal policy has evolved companion concepts of "sustainable fiscal deficits" and "sustainable debt accumulation". In this context, deficits and the resulting debt are sustainable to the extent that borrowing facilitates robust economic growth,that is sufficient to ensure that nominal GDP grows at least as fast as public debt and that debt servicing does not excessively encroach on essential social and economic expenditure. The implications include the imperative to borrow strictly for investment in human and physical capital and to avoid borrowing to finance recurrent expenditure.

The mode of financing of deficits has implications for the debt sustainability process. For some economies, especially in the Americas, there was resort to monetization and inflation. This was accompanied by a perspective that growth needed to be “lubricated” by moderate inflation. Ultimately, the resulting instability and the welfare and economic costs encouraged a retreat from this perspective.

The non-inflationary financing of fiscal deficits from domestic financial markets may, like inflationary financing, drive up domestic interest rates and have the effect of crowding out private sector borrowing. External financing avoids the domestic crowding out issue and may provide needed foreign exchange. External overexposure may however increase the vulnerability of the economy to external fluctuations and will restrict any capacity for inflationary reduction of the burden of the domestic debt.

3. IMF Programmes and Economic Growth

The International Monetary Fund (IMF) in it’s over fifty years of existence, has interfaced with a changing international economic environment. With the World Bank as its sibling, it was established, at the end of the Second World War, as a mostly autonomous member of the United Nations family of organizations.

The establishment of the IMF was informed by the experiences of the Great Depression of the 1930s. In the context of sustained contraction in demand and output, the more developed market economies had sought to “protect” their domestic producers and markets by the use of tariffs and quotas and by competitive exchange rate devaluations that effectively neutralized each other. These responses, by inhibiting specialization and exchange, effectively deepened the depression, the effects of which were only finally ameliorated by spending by Governments in the war of 1939-1945.

The Bretton Woods (New Hampshire) conference in July 1944, established what came to be known as the Gold Exchange Standard. This was a system of fixed exchange rates between the major currencies, with the United States Dollar as the major reserve currency being convertible into gold at a fixed US$ price per ounce. The defining role of the IMF was to maintain orderly conditions of international exchange by avoiding the trade and exchange restrictions and precipitate devaluations of the 1930s. The IMF's role in oversight, review and technical support was supported by the capacity to provide international liquidity support for "temporary and reversible" balance of payment problems.

From the late 1950s to the 1970s, decolonization significantly expanded and changed the character of the membership of the IMF. Prior to its enlarged engagement with issues of transforming developing economies, however, the IMF witnessed the demise of the Gold Exchange Standard over which it had been established to preside. A proliferation of United States Balance of Payments deficits in the 1960s, related in part to the prosecution of war in Vietnam, undermined the convertibility of the United States dollar for gold. The United States, in 1973, formally suspended its guarantee of convertibility and the major currencies drifted into a system of floating against each other.

With many ex-colonial economies having variations of modified currency boards, fixed exchange rates and dollarization, the IMF has subsequently presided over a world with different sets of exchange arrangements. While different currents on exchange arrangements have ebbed and flowed within the IMF, the institution has then never officially endorsed any particular system as being universally ideal. The consistent focus has been on the establishment and maintenance of international competitiveness through the real effective exchange rate.

From the 1970s to the !980s, the formation of the Organization of Petroleum Exporting Countries (OPEC), the recycling of Petrodollars as loans to developing countries faced with higher oil import prices and increasing international interest rates contributed to balance of payment and external debt problems in developing countries. For some developing economies, inefficient use of borrowed resources coexisted with the reality of negative exogenous shocks. Coinciding with the resurgence of economic liberalism in developed market economies, developing countries, from the late 1970s, turned to the IMF for Balance of Payments support.

In what has come to be known as the "Washington Consensus", the IMF along with other Washington based multilateral financial institutions and the external assistance arms of the United States Government, evolved an essentially market oriented approach to correcting balance of payment problems and economic transformation of developing countries. This approach entailed, inter alia devaluation, fiscal adjustment, market determined exchange rates, lifting current payment restrictions, and opening the economy to private capital inflows.

The analytics of IMF programmes are based on monetary approaches to the Balance of Payment. In their simplest forms, these approaches see balance of payments problems as resulting from an excess stock supply of money at current exchange rates, resulting in increased private market demand for foreign assets, depreciating pressure on the exchange rate and a loss of official foreign reserves.

Programme design therefore proceeds from an estimation of the demand for money which again in its simplest form replicates the quantity theory of money as the sum of expected inflation and expected real growth. (These inflation and growth projections are not always derived from rigorous model forecasts). Policy seeks to manage money supply growth in consistency with the money demand forecast. Money supply is identically equal to the sum of the net foreign assets and net domestic assets of the banking system. The growth in net domestic assets of the banking system is distributed between increases in banking system credit to the public and private sectors. The increase in net foreign assets is distributed between the the Central Bank (official reserves) and Commercial BanksThe Balance of Payments forecast must be consistent with the change in official foreign assets but also includes estimates for official capital inflows. These official capital inflows plus the banking system credit available to the public sector (after allowing sufficient credit for private sector growth) then define the size of the public sector deficit that can be financed.

IMF programmes for developing countries in the 1970s and 1980s were often uneasy accommodations. From the previous paragraph, it is apparent that the IMF framework has been more of a consistent economic accounting framework than a rigorous economic forecasting mechanism. The accounting framework, towards the ends of moderating inflation, correcting balance of payments problems and rebuilding official reserves, lends itself very easily to monetary and fiscal restraint. The resurgence of economic liberalism in the 1980s also saw the incorporation of insistence on market determination of the exchange rate and interest rates as the strategic “economy-wide prices.” For policy determined (fixed) prices, the appropriate shadow prices should be used (devaluation and positive real interest rates) and for market determined prices, official intervention should be withdrawn.

IMF programmes were essentially deflationary in the short run. They were designed more explicitly to contain demand than to reallocate resources to facilitate growth. The IMF itself posited that its programmes were growth oriented and would eventually result in poverty alleviation. The growth orientation would emerge from the effects of stabilization (on inflation and interest rates) and from the growth oriented impact of having the correct (market determined) set of economy-wide prices. Devaluation would reallocate resources from “non-tradeables” to “tradeables”, and eliminating preferential interest rates would reallocate resources from socially inefficient to socially efficient investment.

The IMF perspective may have overlooked the structural constraints on the balance of payments of developing countries and overestimated the occupational mobility of economic resources in response to market signals. In this vein, the IMF was dogmatic in its approach to programme design. For example, every balance of payments problem was taken as evidence of a “misaligned exchange rate”. Where the nature of it’s adjustment programme would cause short term contractions in living standards, the IMF’s policy dogmatism allowed the it to be cast in a negative light in developing countries. The concept of the IMF “imposing conditionalities” (surviving to the present day) allowed recipient Governments to neither own nor endorse these programmes, undermining their chance of acceptance or effective implementation. With the orientation being more aligned to adjustment, the process of adjustment was not always designed to preserve and enhance the capacity for medium term growth.

The decade of the 1990s saw the transformation of the formerly centrally planned economies to market economies and a new role for the IMF. From the late 1990s into the new millennium however, strong private capital flows and some successful IMF programmes meant that most countries had ended their borrowing relationship with the IMF. Before the full blossoming of the international financial crisis in 2008, the IMF’s income earning capacity had been severely curtailed staff was being contracted and the IMF needed a new “raison d’etre”.

The global crisis gave the IMF a new lease on life. With new liquidity pledged by the major industrialized countries, the IMF’s role was to ensure that countries did not economically collapse in the context of the crisis. Liquidity could be immediately made available to countries where “fundamentals are sound”. For the others, adjustment programmes would have to be negotiated.

The IMF, in the face of criticism, had already engaged in critical introspection and concluded that in several respects, it had been too dogmatic. It also recognized that dogmatism had undermined country ownership of adjustment programmes. The "new IMF" has sought to be more flexible in its approach to policy design and has encouraged countries to specify their own programmes (which still have to be approved by IMF Staff and Board). Programme funding is now more substantial and "front loaded". There still remains the challenge, however, of facilitating growth in a context of requirements for deep adjustment. This is especially important to facilitate the capacity to service debt.

4. The Record of Fiscal Deficits, Fiscal Allocation, Public Debt and Economic Growth in Jamaica

From the attainment of full internal self Government in the 1950s, Jamaican Governments have assumed responsibility for managing and facilitating economic growth and the enhancement of economic welfare. In the transition from colonialism to independence from the 1950sto the 1960s, fiscal policy and monetary arrangements were conservative and Governments pursued import substitution industrialization and export diversification by means of an extensive system of tax incentives. In that context, Jamaica experienced strong economic growth with low inflation.

Despite indications of macroeconomic progressin the 1960s , there was negative social reaction to perceptions of inequity in the distribution of the fruits of economic growth. With a change in political regime in 1972, the new administration committed itself to social reform and economic redistribution. With limited focus on macroeconomic resource constraints and a loosening of restrictions on central bank financing of the public sector in 1976, there were, from the mid 1970s. increasing fiscal deficits, sharp increases in public debt, higher inflation and a sharp deceleration in economic growth.

Regime change in late 1980s saw a strong resurgence in foreign inflows. Coinciding with the recessionary impact of sharp oil price increases, these inflows were more facilitatory of consumer imports than a resurgence of economic growth. By 1983, there were signs of fiscal deterioration, and balance of payments and foreign exchange system problems. Sharp adjustment between

1984 and 1985 addressed the fiscal problem but with significant social welfare costs including retrenchment of public sector employment. 1985 ended with sharp disagreement between the Government and the “Washington Consensus” regarding the imperative for devaluation as a catalyst for economic recovery and borrowing agreements.

In January 1987, the Government of Jamaica entered a Stand-by borrowing agreement with the IMF but without an upfront adjustment of the exchange rate. In 1987 and 1988 there was fiscal conservatism, low inflation and fairly strong growth in a benevolent international environment that favoured Jamaica’s mineral exports. Despite these improvements, Jamaica’s foreign exchange problems persisted. Parallel markets coexisted with de facto rationing through the official foreign exchange market. The Official Net International Reserves were still negative by approximately US$700mn.

Substantial inflows of external assistance occasioned by the passage of Hurricane Gilbert in September 1988 did little to relieve persistent excess demand for foreign exchange. Accordingly, the new political regime, assuming power in February 1989, was immediately challenged by this problem. From a position of financial weakness and with the strong encouragement of the multilateral financial institutionsand elements of the domestic private sector, Jamaica fully liberalized its foreign exchange system between September 1990 and September 1991.This liberalization eventually (by the mid 1990s) facilitated a substantial correction of Jamaica’s chronic foreign exchange problems but the context of its implementation created other problems.

Jamaica liberalized its foreign exchange system without adequate support from demand management and without adequate legal empowerment of its financial regulatory framework. This contributed to a sequence of sharp inflation (encouraging loose administration of financial institutions) and disinflation, as well as to a limited capacity of financial regulators to arrest the burgeoning of malpractice in the administration of financial institutions. The financial sector meltdown of the mid 1990s and its resolution through the issuance of public debt contributed significantly to the transition from moderate to overwhelming public debt burden.

For fiscal years 1989/90 to 1994/95 including its 1992-95 Extended Fund Facility with the IMF, Jamaica ran fiscal surpluses ranging from 2.1% to 3.4% of GDP. In fiscal year 1995/96, there was a fiscal surplus of just under 2% of GDP. For fiscal years 1989/90 to 1995/96, interest expense remained below 9%of GDP.

In 1996/97 the ratio of public debt/GDP was approximately 80%. This ratio increased nto 1005 in 199/00 and peaked at 142% in 2002/03. This increase was driven largely by the increase in domestic debt flowing from the financial resolution of the financial system crisis that cost $140 billion, about 35% of GDP in 2002/03. Up to the mid 1990s, public debt had been dominantly external. By 2002/03, domestic debt constituted about 60% of the total.

Interest expense increased to 11% of GDP in 1996/97. This increase emanating from domestic interest expense was exacerbated by an increase in external interest expense from 1999/2000. The ratio of interest expense to expenditure and GDP has remained above 12% from 1999/2000 and the ratio of interest expense to total expenditure exceeded 40% for every year from 1999/00 to 2005/06.

Wages and salaries also increased sharply as percentages of the budget and GDP. Up to 1995/96, wages and salaries had been under 8% of GDP. In 1996/97, this ratio jumped to about 10% of GDP and has subsequently exceeded this level with peaks of over 12% in in 2002/02 and 2002/04.respectively. As a share of total expenditure, wages and salaries have exceeded 30% for most of the past two decades (1989/90 to 2008/09) meaning that the sum of interest expense and wages and salaries have occupied over 70% of public expenditure for most of those years.

It is worthy of emphasis that reported fiscal deficits have not been the only source of increase in recorded public debt. As a reaction to tight fiscal constraints there was resort to “deferred financing” where infrastructural projects are undertaken by private contractors through banking system financing with at least implicit Government guarantee. In subsequent years when these debts are assumed by Government, there may be an increase in public debt without concurrent recorded expenditure. Government in 2004/05 committed to cessation of the use of this type of financing.

The other major source of disjuncture between fiscal performance and debt accumulation arises from debt accumulation by severely underperforming public enterprise that eventually has to be assumed by central government. The contributions of Air Jamaica and the Sugar Company of Jamaica are outstanding in this regard, Over the past decade, Jamaica has remained one of the most heavily indebted countries in the world. The debt/GDP ratio was approximately 140% in 2002/03 and fell slowly to 126% in 2007/08. From a revision in nominal GDP, the figure for 2007/08 was revised from 125% to 108% and on the new basis increased marginally to 108.9% for 2008/09.. This revised figure is still high by international standards. Furthermore, a higher nominal GDP is meaningless to the resolution of debt problems, unless it translates into a higher collection of revenue to reduce the fiscal deficit.

The revenue system is heavily burdened by hundreds of tax incentives that date back to the late colonial and early independence era. These have been cited by Bahl and Wallace and by the Matalon Committee on tax reform as foregoing almost as much tax revenue as is actually being collected. These incentives are given ex ante and there is no economic accounting for the impact of these incentives. Beyond these incentives, there is need for tax reform for equity and efficiency. The proposals emerging from the Matalon Committee lean towards substitution of indirect taxes, equalization of corporate and personal tax rates, the elimination of zero rated and exempt items for consumption taxes, with the enhacement of social safety nets where necessary.

There is an obvious symbiosis between public debt of of the significance of Jamaica,s and the recurrence of fiscal deficits. The weight of debt servicing severely restricts room for essential social and economic expenditure unless there is acceptance of a larger fiscal deficit. For the past decade, debt servicing (as interest and amortization) have pre-empted over 50% of the overall expenditure budget and over 60% in some years. A larger fiscal deficit, however, adds to the debt and continues the circularity by feeding back to pre-emption of resources by higher debt servicing.

In the years following the resolution of the financial sector crisis, the Washington Consensus reflected pessimism regarding Jamaica adjusting its way out of its debt burden. This would require several sequential years of primary surpluses that have double digits as a percent of GDP. Governments of Jamaica, however, have never embraced the alternative of a negotiated reformulation of the public debt and have restated commitment to adjustment through large primary surpluses to eliminate the fiscal deficit.

Against the perceived odds, Jamaica has remained current in its debt service obligations while largely avoiding inflationary financing from the Central Bank.

Jamaica's commitment to pay its debt, supported by constitutional prioritization, has found resonance with international financial markets. While not being continuously sustained, Jamaica has run double digit primary surpluses indicating some commitment to fiscal adjustment. Jamaica had double digit primary surpluses from 1989/90 to 95/96, in 2000/01 and from2003/04 to 2006/07 with a peak of 13.6% in 2000/01. The ratio of debt servicing to overall expenditure fell from over 60% in 2005/06 to 52% in 2007/08. Jamaica had also committed to external borrowing only to the extent of requirements for amortization. As a result, Jamaica was able to borrow to refinance debt while recording a marginal easing of the debt burden.

In the context of deep adjustment, exogenous shocks and errors and omissions in the budget have usually resulted in an ex post increase in recurrent expenditure and a crowding out of capital expenditure. From 1988/89 to 1995/96, the ratio of recurrent expenditure to revenue and grants varied in a range of 70% to 90% of GDP. From 1995/96, with the exception of two years, the ratio has exceeded 100%, being as high as 119% in 2002/03. The implication is that deficit financing has been used for recurrent expenditure thereby limiting its capacity to facilitate economic growth. This has contributed to weak economic growth that has averaged about 1 % per annum over the past decade.

The selective allocation of incentives also contributes to the macroeconomic inefficiency of investment by facilitating dynamism in some sectors that does not permeate the rest of the c. In a context of still increasing debt and debt service, the marginal easing of the debt burden has therefore been dependent on inflation. While inflation may ease the burden of domestic debt, by putting pressure on the exchange rate, it may increase the burden of the external debt.

Despite marginal and intermittent improvement, Jamaica's fiscal accounts remained heavily encumbered by debt servicing and wages and salaries. Within tight resource constraints, the fragility of the fiscal accounts has been repeatedly exposed by weather related and international commodity price shocks. As a result, fiscal targets have been missed and medium term targets towards resolution of the debt problem have had to be restated on several occasions. An earlier profile had envisaged the elimination of the fiscal deficit by 2005/06.By the last quarter of 2007/08, the expected year of elimination had shifted to 2010/11. This too will not be realized.

The missing of fiscal targets raised critical questions about adjustment fatique. The international financial crisis from late 2008, severely exposed the external vulnerability of the Jamaican Economy and was catalytic to debt rating negative outlooks and downgrades and the initiation of negotiations for a new borrowing agreement with the IMF.

5. The Impact of the Global Financial Crisis Policy Reaction, the IMF and Options for Adjustment

Jamaica had a change in political regime in September 2007. The new regime committed itself to fiscal prudence and the continued honouring of debt obligations. Its debt management strategy relied significantly on aggressively pursuing lower cost external financing from multilateral financial institutions. It did not entirely rule out refinancing from international financial markets however and borrowed US$350 million from these sources in June 2008. Subsequently, the combination of the global crisis and Jamaica's continuing fiscal problems effectively closed the private market financing option.

In an environment of limited fiscal space and hurricane related flood damage in August 2007, there was a small reported deviation from the deficit budgeted tor FY 2007/08. Relative to a target of 4.5% of GDP, the deficit was reported as 4.7% of GDP. At the end of that fiscal year, the ratio of Debt to GDP was still reported as approximately 126% (later revised to 108%)

The Government indicated its commitment to fiscal reform and prudence to domestic and international financial markets. With a fiscal deficit target of 4.5%% of GDP for FY 2008/09, the Government registered its intention to progressively reduce this deficit in the medium term. The deficit target was based in part on an amnesty for outstanding tax payments. International financial markets responded positively by lending US$350 million to Jamaica in June 2008. This was a ten year instrument at 8%.

Revenue performance in FY 2008-09 did not meet expectations and public sector settlements drove payments for wages and salaries to over 11% of GDP. With payments of interest on public debt exceeding 13% of GDP, the fiscal deficit for the financial year approximated 7% of GDP.

The emergence of the international financial and economic crisis in late 2008 severely exposed the fragility of the Jamaican economy. Economic recession in the North Atlantic affected Jamaica's Bauxite/Alumina industry to the extent that three alumina processing plants and the one bauxite exporting facility closed leaving just one alumina plant still operating. By means of aggressive promotion, visitor arrival numbers were sustained, but at the cost of sharp discounting. There was also a sharp decline in remittance flows from late 2008 to the middle of 2009.

There were margin calls on local financial institutions that had exposure to foreign financed holding of questionable externally issued assets. This informed a commitment of a US$300 million line of credit (15% of official foreign reserves) by the Central bank, to guarantee the stability of the domestic financial system.

In this environment, there was an increase in the Jamaica dollar price of the United States dollar by about 20%. This exacerbated the inflationary pressures that had already been apparent in the economy. From the reduction in external demand and in foreign exchange inflows, there was output contraction and an increase in unemployment in the Jamaican economy.

With clear signs of deterioration in Jamaica's fiscal and external accounts, international debt rating agencies, from late 2008, issued warnings about potential downgrades of Jamaica's debt. Standard and Poor's in particular, in November 2008, pointed to the extreme fragility of Jamaica's external accounts and its limited degrees of freedom for policy response. This would have pointed in particular to the limited room for fiscal adjustment.

Despite the clear signs of economic deterioration and sharp warnings from international rating agencies,, there appeared to have been a significant recognition lag on the part f the administration. For the last quarter of 2008 and much of the first half of 2009, there appeared to be official denial of the severity of the impact of the international crisis and the need for any borrowing arrangement with the IMF..

In response to significant pressure on the exchange market, exchange rate depreciation and the reduction in official foreign reserves, and in the absence of any fiscal response, the Central Bank, in late 2008, sharply increased interest rates by some 800 basis points. This would add significantly to the government's debt service costs in 2010.

With no effort to arrest the deteriorating fiscal situation, Fiscal year 2008/09 ended with a deficit of over 7% of gross Domestic Product. On the pre-existing data series, the ratio of debt to GDP would still have been over 120% but a revision of nominal GDP yielded a ratio of 108.9%.

The budget for 2009/10 was cast in a context of a chronic debt constraint, narrowing fiscal space, and unsettled public sector wage negotiations. With the announcement of a new tax amnesty, there was renewed government optimism on revenue performance. Despite revenue optimism, recognition of expenditure commitments led to a fiscal deficit target of 5.5% of GDP. It is especially worthy of note though, that the budget presentation did not include a medium term profile. Such a profile would be necessary to chart the path of Jamaica's adjustment from its burden of public debt.

By the second month of the financial year (May 2009) it was emerging that the revenue forecasts for the financial year were significantly overoptimistic..By August 2009, there was a cumulative revenue shortfall of about 1% of GDP, increasing further to 1.5% of GDP by end September 2009.. Government responded by restricting capital expenditure but it was increasingly apparent that with public sector emoluments and settlements outstanding, there would be very substantial deviations from budget for the fiscal year.

A central tenet of the administration was the substitution of lower cost multilateral debt for issues on international financial markets. Negotiations with the World Bank, the Inter American Development Bank (IDB) and the Caribbean suggested to Government that substantial incremental funding would be available. Additionally, there were commitments of grant financing from the European Union. While the Government, into the first quarter of 2009, continued in its uncertainty regarding reengaging a borrowing agreement with the IMF, the other multilaterals would have become increasingly concerned about Jamaica's debt sustainability. For these institutions, resolution of these concerns would be dependent on substantial fiscal reform within the formality of an IMF borrowing agreement. This would be seen as especially necessary given Jamaica's history of setting and missing fiscal targets while appearing to avoid socially and politically difficult economic choices.

By July 2009, Jamaica initiated negotiations for a new borrowing agreement with the IMF. With increased resources available to the IMF and with its commitment to more generous antirecessionary funding, the Government expected US$1.2 billion from the IMF in the course of a Stand-by Arrangement. Furthermore, in keeping with the IMF's new modus operandi, funding was expected to be "front-loaded' rather than spread evenly over the life of the arrangement. It is now apparent that in entering these negotiations, the government of Jamaica either did not have a medium term profile, or one that was acceptable to the IMF.

Standard and Poor's, in July 2009, downgraded Jamaica's debt. In this regard, they again cited Jamaica's fiscal and external debt vulnerability. They also cited what they referred to as the Government's engaging in "distressed debt transactions". This was apparently in reference to discussion between the Government and elements of the private sector on restructuring the terms of of elements of existing debt.

In September 2009, even while negotiations with the IMF were continuing, the Government tabled its first supplementary estimates. In the context of increased interest expenditure of $16 billion and increased wage settlements of $7 billion and other "inescapable commitments" of $4 billion, capital and other elements of recurrent expenditure were cut by $21 billion. Non-interest recurrent expenditure was cut by $4 billion and capital expenditure by $5.7 billion. When juxtaposed with the $16 billion increase in interest expense this yields an increase in expenditure of $6 billion.

Relative to this increase in expenditure of $6 billion, it was subsequently conceded that the financing requirement would increase by $25 billion. This suggests a revenue shortfall of over 2 % of GDP. The revised fiscal deficit would be almost 9% of GDP raising questions about the future of the debt burden and its servicing.This points to the imperative for a credible medium term profile.

The supplementary estimates were rigorously examined and debated in parliament and the wider society. Concerns were raised about the sustainability of programmes, social and economic welfare and the realism of revenue and financing options. Note was taken of reductions in recurrent expenditure for agriculture, education, health, national security and transport and works. For Capital A (financed wholly by Government) there were cuts in the "Constituency Development Fund" (administered by the Office of the Prime Minister through Members of Parliament), Education, Agriculture and Transport and Works. For Capital B (cofinanced by external agencies), there were increases for Health and Agriculture but decreases for Education, Water and Housing and Transport and Works.

The Prime Minister's contribution to the debate sought to highlight the extreme seriousness of the chronic debt problem and the need for deep adjustment. Following earlier statements that were at best equivocal, the Government indicated explicitly that there would be a fundamental restructuring of Government, , to begin at the start of fiscal year 2010/11. This would be in recognition of the implausibility of fiscal adjustment consistent with debt sustainability, given the existing structure and functions of Government.

The Government remains committed to paying its debt on schedule. This means that fundamental debt restructuring is not seen as an option. Given the weight of the debt and its servicing, policy has to critically examine all the options available for making the debt more manageable. In weighing the options, cognizance has to be taken of potential social, political and economic repercussions arising from the process of adjustment.

6. Analysis of the Prospects for Growth and Debt Sustainability

From the late 1990s, the Wahington based multilaterals had expressecd concern regarding Jamaica’s capacity to sustain the ending of its borrowing relationship with the IMF. By means of significant fiscal sacrifice as reflected in large primary surpluses, and with the engagement of international financial markets, Jamaica was able to sustain its independence of borrowing from the IMF for over a decade. It continued, however, to rely on an IMF seal of approval through Article IV consultations and IMF staff monitoring of macroeconomic programmes designed by Government of Jamaica economic technicians.

Initially, borrowing from intetrnational financial markets was for relatively small amounts, for relatively short tenures and at relatively high interest raes (12-13%). Over time, and by remaining committed to large primary surpluses and the repayment of debt and by progressively building official net external reserves to over US$2 billion, Jamaica was able to significantly improve the terms of its external borrowing. By 2008, Jamaica had been able to issue in sufficiently large volumes (US$500million) to make the emerging markets index, issue for thirty years and at approximately 8% per annum.

While Jamaica was not borrowing from the IMF, it continued to borrow for programmes and projects, from the IDB, the IBRD and the CDB, and continued to attract bilateral grant financing. These institutions too, were encouraged by commitment to large primary surpluses and debt repayment and the substantial improvement in the external accounts and foreign reserves. Although external commercial market borrowing was restricted to amounts necessary for annual amortization, this source dominated official external financing.

Despite its commitments to adjustment, Jamaica continued to miss its precise fiscal targets and after 2007/08, its primary surpluses declined. sharply. Never far from the surface of multilateral financial institution and international financial market concerns, questions arose about whether Jamaica was “suffering from adjustment fatigue” and whether sustaining the process of deep and painful adjustment was socially or politically tenable.

With the change in political regime from late 2007, the new Government committed itself to “reengagement” of borrowing from multilateral financial institutions as a more cost effective source of external financing. As it negotiated with multilateral and bilateral external sources, however, it continued to rely on informal programme monitoring by the IMF. Unfortunately however, Jamaica for the Fiscal Years 2007/08 (the year of political regime change) 2008/09 and 2009/10, Jamaica continued to miss its fiscal targets and run substantially lower primary surpluses than necessary for debt sustainability. From 2008/09, the international financial and economic crisis severely exposed the external vulnerability of the Jamaican economy and the failure to arrest fiscal deterioration in 2008/09 and 2009/10 would have added to growing concerns about debt sustainability. These concerns were summarized in assessments, negative outlooks and downgrades presented by international debt rating agencies.

In the last quarter of 2008/09, a it was explicitly indicated that without extraordinary foreign exchange inflows, Jamaica’s official external reserves could be expected to fall by over US$800 million in the course of 2009/10.The Governor of the Bank of Jamaica signalled the need to reengage a formal borrowing arrangement with the IMF. Throughout the presentation of the budget for 2009/10 and the first quarter of 2009/10, this position was not officially endorsed by the Government. By July2009, the Government had initiated “exploratory talks” with the IMF.

Concerns about the budget, revenue expectations in particular, were being validated by June 2009. Beyond overoptimistic revenue forecasts and the likelihood that the fiscal deficit would significantly exceed programme, the presentation of the budget had the peculiarity of not including a medium term programme to chart Jamaica’s macroeconomic path of adjustment from its severe burden of public debt. In this context, and against the background of missed fiscal targets and clear prospects for severe official foreign exchange losses, the prospective sources of external financing would have been reluctant to commit large new flows to Jamaica without strong guarantees of debt sustainability. This would have defined the context of and the rationale for negotiations on a formal borrowing agreement with the IMF.

Relative to the old concerns about the "imposition of conditionality" by the IMF, the extreme seriousness of the IMF's role is to be clearly recognized. The IMF may be less dogmatic about exchange rate and interest rate policy and it may be more generous in its provision and front-loading of resources. At the same time, the IMF is being relied upon to certify that the heavily debt burdened Jamaican economy will be able to manage the servicing of existing debt and the substantial new inflows expected from the multilaterals, including the IMF itself.

Jamaica's capacity to service its debt will be dependent on its prospects for escaping from economic stagnation. This is in turn largely dependent on the prospects for North American and global economic recovery. As the pundits expectantly look for "green shoots", the consensus appears to be that the international recovery will be slow and halting (stop and start) and that growth will be anaemic at least until the middle of 2011.

Even as the international economy recovers, there are concerns about the international technological and cost competitiveness of major Jamaican sectors including bauxite/alumina. Encouraged in part by the system of tax incentives, there is a dualistic process of development where the dynamism of modern sectors such as tourism is not functionally linked to the modernization of backward sectors such as agriculture.

There continue to be concerns about the impact of tightening monetary policy on private investment and public debt servicing costs. There is continuing private sector interest in engineering lower interest rates to lead the growth and debt service reduction process. Interest rates, however are likely to be largely endogenous where lower interest rates cannot be sustained unless Government sharply reduces its financing requirement.

Following several years of weather related disruption, Jamaica in 2008 and 2009 has been relatively free of hurricane, flood and drought. The continuation of fiscal problems is however related to the past impact of these types of shocks. Elements of public infrastructure have not yet fully recovered from hurricanes past. Furthermore, the possibility of future shocks represents an extremely severe threat to fiscal accounts already made vulnerable by the burden of external debt.

The fiscal drag of loss making public enterprises has not been effectively resolved. Deadlines for divesting Air Jamaica by end March 2009 and end July 2009 have been missed. A proposed sale of the assets of the Sugar Company of Jamaica failed and only one of the smaller sugar manaufacturing entitities was sold to another enterprise. The divestments need to be completed and other public enterprises either divested or rationalized.

Within the context of a severe debt constraint, Jamaica faces the challenge of combining sharp fiscal adjustment to ease the burden of external debt, with an imperative to reallocate economic resources to facilitate economic growth. Sharp fiscal adjustment would also facilitate lower debt servicing costs by easing the pressure of the government financing requirement on interest rates. Huge primary surpluses and lower fiscal deficits are arithmetically necessary to constrain the expansion of debt and debt servicing. This will require both expenditure restraint and revenue enhancement.

Traditionally, Jamaica has attempted expenditure restraint within an unchanging governmental structure and establishment with the same ambitious set of functions. This approach of trying to do all the same things with less money undermines service delivery and increases the prospects for budget overruns. As reflected in the Prime Minister's contribution to the parliamentary debate on the first supplementary estimates for 2009, Jamaica is facing the prospect of reducing the scope and functions of Government, having implications for, inter alia, the number of ministries, the size of the Cabinet and public sector employment. While reduction of public sector employment may facilitate expenditure restraint in the medium term, there may be immediate increases in expenditure requirements for redundancy payments.

The facilitation of growth requires a reallocation from recurrent to capital expenditure and that there is a reorientation to ensure that net borrowing is used to finance capital expenditure. Beyond public sector labour emoluments, recurrent expenditure is dominated by interest expenditure and pensions. The effective management of interest expenditure has to do with compressing the deficit that will also have the effect of reducing interest rates. As discussed above, a reduction of the deficit may not be feasible without a deduction in the size and scope of Government. For pensions, the adjustment of future commitments may only occur slowly over time (as existing employees retire and come to the end of the life cycle over the next 50 years), or as for retrenchment of employment, implies increased expenditure to buy out existing contracts.

Recurrent expenditure has to be reduced to the extent necessary to ensure that revenue exceed recurrent expenditure. This is to ensure that the financing requirement relates exclusively to the financing of capital expenditure. After 2008/09 when recurrent expenditure was only about 103% of revenue, the budget for 2009/10 increased this ratio to about 113%. The supplementary estimates may have increased this ratio further to 120% of GDP, in consideration of the increase in expenditure and the underperformance of revenue.. This compounding of the recurrent expenditure problem relates almost exclusively to wage and interest commitments which then also become automatic commitments for the medium term. At the same time, the widening of the fiscal deficit increases debt and commitments for the future.

The facilitation of economic growth demands emphasis on expenditure to increase the economy's stock of human and physical capital. Physical capital relates to public infrastructure while human capital relates to expenditure on healthand education. Expenditure on national security and social safety is of general societal value but will also directly reduce the costs of doing business and in enhancing citizen well-being, enhance the value of human capital. Public expenditure also needs to support indigenous research and development, related especially to the domestic resource base, and the productive adaptation of technology developed in the rest of the world.

The management of revenue is also germane to the prospects for growth oriented adjustment. While revenue enhancement is required to moderate and reduce the fiscal deficit, the structure of taxation may be more or less facilitatory of growth. As a matter of greatest urgency, critical review of the tax incentive system is required to inform reform to enhance revenue and rebalance economic growth. There is limited prospect of getting a true accounting of the economic impact of existing incentives but the revenue foregone is easy to estimate. It would not be inappropriate to dismantle the entire system of incentives and recast them on a reimbursable basis against clearly specified performance objectives. The sectoral allocation of these incentives may also have to be reconsidered, in the interest of facilitating a more balanced and less vulnerable economic structure.

While indirect taxes are posited as being a relatively efficient form of taxation, the General Consumption tax is riddled with zero ratings and exemptions. While these are advanced as a means of advancing social welfare, they represent a larger value subsidy to individuals with higher incomes who are better able to afford quantities of these commodities. The revenue loss for these ratings and exemptions is such that their elimination could finance the confluence of some lowering of the general rate and financing a social safety net for the most economically vulnerable.

The supply-side orientation of Bahl and Wallace and the Matalon Committee lean towards a unification and lowering of rates of direct tax on incomes (corporate and personal), and an increase in the rate of indirect tax. Subject to revenue enhancement through reforming incentives and the gaps in the GCT, it may be feasible to reduce corporate tax rates to equality with personal tax rates. Substantial further reductions in income tax rates financed by increases in the GCT may be counterproductive (encouraging underground economy) and regressive (to the extent that poorer people spend a larger fraction of income on consumption.

There is much to be said for rationalizing and simplifying the system of taxes impinging on doing business including property and transfer taxes, and taxes on dividends. The greatest incentives for business are, however, likely to lie entirely outside of the tax system. These would include the efficiency of public bureaucracy, education, social stability and the state of national security.

It is especially challenging that in a depressed economy that needs to grow, the debt constraint demands a more proscribed role of Government. This presents the opportunity, however, to critically re-examine the definition of the preferred role of Government. Governments in developing countries need to ensure that in accepting responsibility for economic transformation, they do not fall prey to relatively unproductive interest group or bureaucratic capture.

7. Conclusion

The Jamaican economy, by late in 2009, has been struggling under the weight of an extraordinary debt burden for over ten years. Despite commitment to remain current in its debt payments supported by some significant effort at fiscal adjustment, this effort has not been sufficiently sustained to fundamentally correct the problem. Over the decade, vulnerability has been exacerbated by weather related exogenous shocks. From the last quarter of 1988, the fragility of the Jamaican economy has been severely exposed by the impact of the international financial and economic crisis. In this regard, there has been a sharp contraction of foreign exchange inflows. The economy, after years of anaemic growth, has been contracting with attendant increases in unemployment. There is every prospect of this contraction continuing in 2010.

While the prospect of external financing offers some help, this financing cannot logically be to finance sustained or increasing fiscal deficits. The IMF finds itself cast in a role of having to guarantee that Jamaica will be able to sustainably service its existing and anticipated additional debt. Towards this end, Jamaica will need to define a credible medium term path for progressive elimination of the fiscal deficit. This adjustment in the aggregate, promises to be pro-cyclical in an already contracting economy. As a deepening of the recession would further undermine the fiscal capacity to service increasing debt, the challenge is to reallocate more limited fiscal resources and to reform the taxation system to facilitate recovery of economic activity.

Jamaica is faced with this challenge of defining and undertaking growth friendly adjustment after a decade of fiscal effort varying between moderate and extreme, where social services are under strain and where there are unsettled public sector wage negotiations. The degrees of freedom for adjustment are therefore limited. In this regard, the recent succession of weak budgets and the increase in the fiscal deficit target for 2009/10 have further reduced these degrees of freedom. Jamaica is running out of time for adjustment. Protracted delay in arresting the problem makes resolution without extraordinary means less feasible.

The required policy intervention through expenditure and revenue management would have significant costs to various segments and interest groups in the Jamaican society. This may include extracting revenue from people not accustomed to paying, radically reforming tax incentives and reducing functions and employment in the public sector. Both expenditure and taxation reform can have significant social welfare costs that if not effectively managed, may yield negative social reaction.

It has been conceded that the economy is in crisis. This paper has attempted to explore in summary fashion, the technical policy directions necessary for resolution. There must also be recognition that successful management will demand significant political courage, transparency and effective communication and a sense of equity in burden sharing.

References

Solow R.M. (1970) : Growth Theory: An Exposition, Oxford, Oxford University Press

Lucas R.E. :Supply-Side Economics; An Analytical Review, Oxford Economic Papers 42: 293-316

Bahl R. And Wallace S (2007): TaxReorm and Economic Development in Jamaica, PIOJ

Easterly W. and Rebolo S.(1993): Fiscal Policy and Economic Growth, Journal of Monetary Economics 32, 417-58.

Government of Jamaica: Memorandum on the Budget (Various Years).

Government of Jamaica: Estimates of Expenditure (Various Years)

Government of Jamaica: First Supplementary Estimates 2009/2010.

Planning Institute of Jamaica: Economic and Social Survey of Jamaica (Various Years)

Bank of Jamaica: Annual Report (Various Years)

Bank of Jamaica: Quarterly Monetary Policy Report (Various Issues)

World Bank : The Road to Sustained Growth in Jamaica (2004)

World Bank: Jamaica: Fiscal Consolidation for Growth and Poverty Reduction, Report No. 29546-JM, February 2005

Khan Moshin S. and Knight Malcom D. :Fund Supported Adjustment programs and Economic Growth, IMF Occasional Paper 41, November 1985