

This article is part I of a series that will take a critical look at the challenges facing Jamaica on the Fiscal and Balance of Payments front, with suggested policy solutions to address these challenges. Part I in the series focuses on Jamaica's credit ratings and the implications of further rating action on the debt dynamics in the context of the 2009/10 budget and the implications of negative rating actions on the Jamaican economy.

Overview of Fiscal Challenge Facing Jamaica

Jamaica's budget and debt dynamics are reeling from the full effects of the twin global crises of turmoil in credit markets and economic recession. Jamaica's debt ratio of approximately 113% of GDP (2008/09 estimate) is the third highest among all rated countries (S&P), and its budget deficit of approximately 6% of GDP (2008/09 estimate) is more than twice that of its B median (S&P) peer average of 2.8% of GDP. The budget deterioration from a deficit of 4.5% of GDP last year was mainly influenced by a severe contraction in revenues relative to budget, equal to approximately 2 per cent of the size of the economy, as consumer and business spending plunged. This occurred even as the authorities attempted to limit overall spending.

The challenges faced by the country are compounded by a continuing weak external financing position – albeit with an improving current account deficit from falling commodity prices – as foreign direct investment (FDI) flows have declined sharply. The resultant 21.7% depreciation of the J\$/US\$ over the past six months added approximately J\$108BN (or 10% of the economy) to the debt stock. When combined with the sharp rise in real interest rates over the same period, the vulnerability of the country's budget and debt dynamics are brought into sharp focus: continuing along this path is clearly unsustainable.

Credit Rating Outlook

Jamaica's vulnerable fiscal position implies that it has little flexibility to react to any domestic or external shock in the new fiscal year if the authorities do nothing. In other words, nearly everything needs to remain close to perfect in 2009/10 if corrective policy actions are not taken. Given the limited flexibility and deteriorating dynamics, the country was downgraded by Standard & Poors to its lowest rating ever (B-) with a negative outlook (**Table 1**). The negative outlook implies that a rating downgrade to CCC may be imminent if corrective policy actions are not taken urgently.

Table 1: Rating Peers

Country	Rating	Outlook	Notes
Argentina	B-	Stable	Defaulted Feb 2002
Bolivia	B-	Stable	
Grenada	B-	Stable	Defaulted Dec 2004

Lebanon	B-	Stable	
Jamaica	B-	Negative	Lowest rating ever
Madagascar	B-	Negative	Lowest rating ever
Pakistan	CCC+	Developing	Defaulted in 1999
Ukraine	CCC+	Negative	Lowest rating ever
Ecuador	SD	N/A	Twice in default
Seychelles	SD	N/A	In Default

Source: Standard & Poor's, JMMB IR; SD - In default

Countries rated CCC by S&P are listed as “currently vulnerable to nonpayment and is dependent upon favorable business, financial and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.” While Jamaica is not close to such a scenario, if it were downgraded to CCC perception could become reality, hence the need to prevent such an occurrence.

Ratings Agency Credibility

Therefore, the credibility of the 2009/10 budget requires appropriate policy actions to reinforce economic confidence and prevent any further downgrades. As stated before, a downgrade could lead to a vicious cycle of rising debt levels and negative growth for a protracted period. Many expressed views have questioned the credibility of rating agencies due to their involvement with the US subprime crisis. These views have made a case for Jamaica to “ignore” its credit rating and act accordingly, and have even suggested that the current ratings on Jamaica should be higher than it currently is. However, the situation is reflective of the exact opposite: credibility questions for rating agencies are due mainly to their perceived leniency and slowness to adjust their ratings to reflect a deteriorating credit profile. This perceived “lagging” by the rating agencies implies a worse, not a better scenario for rated countries. Hence countries ignore credit ratings at their own peril.

Implications of a Downgrade to CCC

The implications of a downgrade to CCC+ could be disastrous and could likely plunge the economy into a prolonged multi-year economic and financial chaos. A country rated CCC could face increased speculation about a forced government restructuring (1 level away from default), which could become a self fulfilling prophecy as economic agents act accordingly:

- ✓ **Deteriorating Government Maturity Structure**: Government’s maturity profile would be significantly reduced to very short term high-interest-rate local paper, which would have two adverse effects: (1) Debt cost would rise dramatically as frequency of debt payments increase, thus ballooning the size of the debt and size of the fiscal imbalance and (2) the government would face “rollover risk” of its short term paper if investors became more unwilling to refinance the debt coming due in J\$ in preference for holding foreign currency.
- ✓ **Capital Flight and Hoarding of Foreign Currency**: This may also lead to hoarding of foreign currency by foreign currency earners resulting in even greater pressure on an already stressed foreign currency market, leading to a severe contraction in the Net

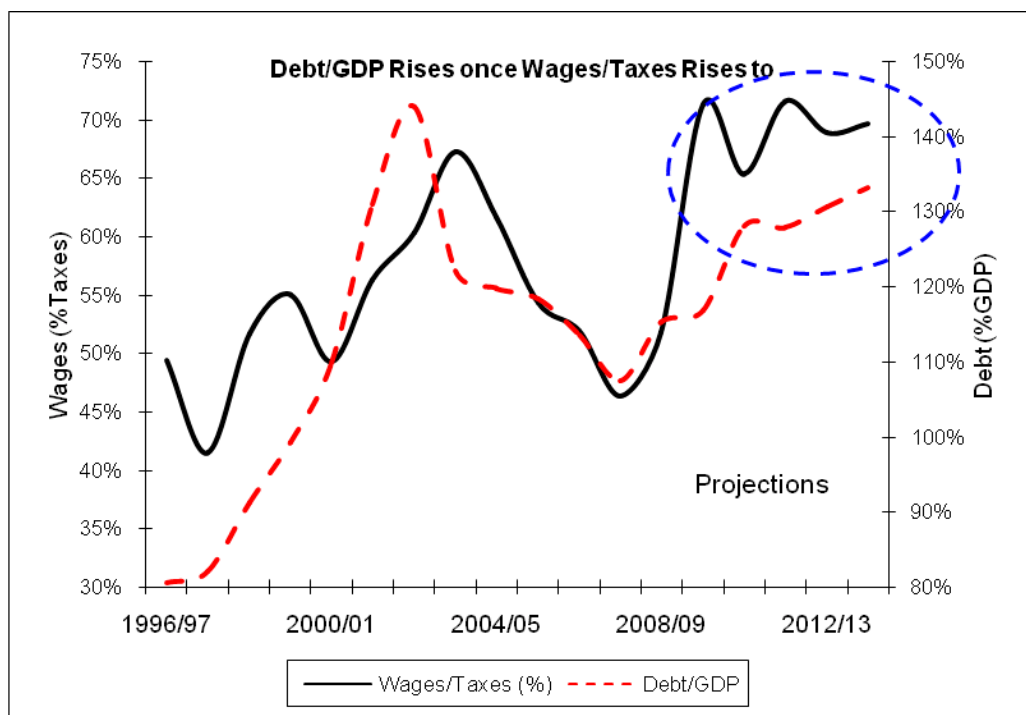
- International Reserves and further hikes in interest rates: a vicious multi-year cycle of capital flight and hoarding.
- ✓ **Credit Lines:** Such a scenario would also lead to a virtual credit crunch from both foreign and local institutions: foreign institutions because of the country risk exposure and local institutions because of an expected severe contraction in corporate and household balance sheets from a vicious cycle of high debt levels, negative growth / employment and high cost of capital.

Towards a Policy Response

Given the implications of a CCC rating, a strong policy response that identifies and addresses sources of instability is absolutely critical to maintaining Jamaica's credit rating in the face of impending negative shocks. This is required to sustainably reduce the debt to manageable levels thus facilitating economic growth. There is simply no other viable solution. Therefore, how proactive Jamaica is in adopting policies to help minimize shocks and the success that it has in accomplishing such fiscal adjustments directly correlates with its respective credit rating.

The first step in credibility requires the targeting of a sustainable reduction in the debt levels. There are two ways of addressing a high debt burden. (i) Jamaica can **raise revenues** by broadening the tax base, introducing new revenue sources, increasing rates, or promoting reforms that improve private sector productivity and efficiency (ii) or, they can **reduce expenditures** by improving public-sector efficiency or cutting government programs and wages and salaries, since these are the expenditures under its direct control, assuming it does not intend to default. Of course, a combination of (i) and (ii) is also viable. In other words, **fiscal prudence is a first order priority for the medium term!**

Figure 1: Debt (%GDP) vs Wages (%Taxes)



A Note on Public Sector Wages

Figure 1 shows the relationship between the debt (% GDP) and public sector wages (% tax revenues). Wages are isolated because it is the largest expenditure item that is directly controlled by the Jamaican authorities without contemplating a default (we will consider interest rates in part II). Wages are assumed to grow at the pre-wage freeze growth rate of approximately 57% of tax revenues (J\$149 billion). Escalating wage bills without a commensurate level of tax revenues is related to increases in the debt ratio because it increases the level of borrowing in order to meet the higher wage bill. In other words, the original projected wage bill was simply unsustainable given the projected fallout in tax revenues and would most certainly have resulted in a downgrade to CCC! Hence the important first step of freezing wages was a necessary action, albeit not sufficient to reduce the probability of a downgrade to CCC.

In part II I will explore a menu of fiscal policy options that are required to reduce the probability of a rating downgrade to CCC. I will also explore the dynamics of reducing the debt over the next three to four years in a sustainable manner.

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