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MAKE SMART CHOICES

7:10 AM Smile Jamaica TVJ

Jason Morris, Senior Investment Analyst, JMMB, offers follow up commentary on the Budget presented by Hon. Audley Shaw in an article posted in the Business Observer.

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Choices Facing the Jamaican Government to Really "Change the Game"

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This is Part II of a mini-part series outlining the challenges facing Jamaica and the menu of choices available to the government at this time.

Last Wednesday, April 15, 2009, we established the importance of avoiding a rating downgrade to CCC given the likely adverse consequences on the economy over a prolonged period. Having established that a credible budget is a first order priority we concluded that Jamaica has no choice but to reduce expenditures. In other words, as difficult a decision as it is, rising public sector wages are inconsistent with a sustainable debt ratio and a declining economy.

Debt Sustainability

The near-term challenge for the government is to chart and maintain a credible, transparent course to improved budget and debt indicators over the next four to five years given the external economic environment. Given Jamaica has the third largest debt/GDP ratio of rated countries in the world its primary budget challenge is to sustainably reduce its debt ratio to manageable levels. However, achieving this target requires both a significant reduction in the budget deficit and maintaining a high primary budget surplus – revenues less non-interest expenditures - of at least 9% of GDP.

In fact, maintaining a high level of primary budget surpluses is the single most important indicator of a sustainable reduction in the debt/GDP ratio. In other words, given our high debt level, the primary surplus which has plunged to 10 year lows of approximately 4.5%, indicates that Jamaica will *not* be able to "grow" its way out of debt unless the primary surplus is increased significantly. Hence the urgent need for a cut in expenditures to sustainably reduce the debt. To its credit, Jamaica has an excellent track record in this area, with one of the largest primary surpluses in the world, averaging 8.2% of GDP over the past two decades.

By cutting expenditures under its direct control now, the government will benefit from a "positive feedback loop" in future periods, i.e. both tax revenues and market determined expenditures will be positively affected: tax revenues will be higher than they would otherwise be due to a faster than otherwise GDP growth from a reduction in government's "crowding out of the private sector"; and interest rates (and hence interest expenses) will fall in a sustainable manner as government's appetite for debt is significantly reduced. This in turn will result in a better than otherwise rate of economic growth, thus creating a virtuous loop.

In other words, enough resources would be generated to pay appropriate public sector wages and adequately meet infrastructure development and social spending needs from tax revenues, rather than having to borrow so much to meet those needs.

In summary, a higher debt/GDP requires a higher primary surplus/GDP to send a credible signal that the debt levels can be sustainably reduced. This in turn requires either expenditure cuts complemented by higher revenues if available, or a combination of both.

Stimulus Package and Fiscal Illusion

Slow fiscal adjustment weakens investors' perception of a country's assets through two channels: it lowers the perceived quality of the government and its decisions; and it reduces the liquidity of the country's assets by crowding out productive investments. Conversely, early adjustment can result in a dramatic improvement in the country's performance, which should be the intention of the current budget.

There have been calls from many quarters for the 2009/10 budget to include some form of "fiscal stimulus", presumably following the example set by developed countries to counter economic declines. However, a "stimulus package", if implemented, would slow the urgent fiscal adjustment required to reduce the debt as outlined previously. This is also due to a "crowding out" effect that is severe in Jamaica, due to the high debt levels, compared with the "crowding in" for a developed country such as the US.

One of the main reasons for this is the difference in "financial" depth, the ratio of domestic credit (given closed external credit) to the private sector as a percent of GDP. Jamaica's ratio is a low 11% of GDP, relative to the US which is approximately 190% of GDP. Thus for Jamaica, spending more during a budget crisis magnifies the "crowding out" effect, resulting in a contraction rather than the intended expansion from the additional spending, as any monies borrowed to finance the additional spending is reflected in a more than one-to-one decline in credit to the private sector, and hence GDP growth. This is not the case for developed economies.

Put differently, there is a negative relationship between "stimulus packages" and GDP growth for crisis- ridden indebted countries such as Jamaica, compared with a positive relationship for developed economies with more financial depth. Hence, agents calling for additional spending do not seem to fully understand the budget constraint of the government. These calls seem to be overestimating the benefits of borrowing money to spend now, since enough revenues are not available, and are thus underestimating the future tax burden and economic decline that this will bring: a simple form of "fiscal illusion".

Sanctity of Contracts: Debt vs Wages

There may be an impression that government's decision to freeze public sector wages is not honoring the sanctity of wage contracts, and therefore this action could also be taken with "restructuring" debt contracts.

However, debt contracts are explicitly senior to public sector wage contracts, given their constitutional first call on revenues. Therefore, the sanctity of the debt contract is not compromised by a decision to freeze public sector wages. In fact, wage contracts are secondary to debt contracts in both the private and public sector everywhere in the world. Simply put, if faced with a decision between defaulting on debt versus containing wages, wage containment is always the first option, as debt may be needed to honor wage contracts in future periods. Undeniably, the converse is highly improbable.

Misconceptions about Debt Restructuring

Many comments have been made to the effect that the government should "restructure" the debt as a possible solution to the current fiscal challenges by spreading the burden of the budget to "holders of capital". There may even be the notion that if Jamaica were to "restructure the debt", it would be able to pay the original J$149 billion wage bill by reducing the said "burden" on public sector employees. At first glance, these seem like logical arguments given 40% of central government spending (from which the "fiscal deficit" is derived) is allocated to interest expenditure, the highest expenditure item. In other words, there may be a suggestion that "restructuring" the debt would reduce the debt overhang thus freeing up more resources to spend this fiscal year.

However, any form of "debt restructuring" would require more stringent government spending not less. Jamaica is constitutionally bound to repay its debt, but let's ignore that hurdle for the purposes of this discussion.

Firstly, the term "debt restructuring" seems to be used loosely. For all intents and purposes, a so-called "debt restructuring" is a default, with the immediate negative consequences of a downgrade (discussed last Wednesday) to "Default" or "SD", unless it is voluntary from creditors. "Defaulting" would defeat the purpose of wanting to spend more, as the monies required to finance spending have to be raised from debt which arguably no one would be willing to buy, or even if willing, the cost would be much greater than if there was no default. Having already discussed the negative consequences of a downgrade last Wednesday, there is no need to repeat them here.

Of course, one may argue that the government could "restructure the debt" with the help of multilateral lending agencies to fill the financing gap left by the unwillingness of purchasers. However, such agencies would require a more stringent path to fiscal prudence than currently being adopted. In fact, a number of multilateral lending agencies have repeatedly recommended a restructuring of the public sector to reduce the un-sustainability of public sector wages. Thus defaulting on the debt actually increases the burden on public sector workers, not the other way around.

"Secondly, a voluntary restructuring is also a default if the creditors are made any worse off than they would otherwise be: the debt has to be repaid and it has to be "net present value (NPV) neutral". NPV neutral really means that a dollar due to be repaid today must be worth its equivalent value if it is repaid tomorrow, or next year, or in 10 years, instead of today. This "neutrality" prevents an automatic downgrade from the action of "voluntary restructuring". In fact, even if creditors willingly took less than the NPV value, it would result in an automatic downgrade to default, i.e. there is no free lunch!

Social Partnership based on Fiscally Prudent Decisions

Simply put, a voluntary restructuring allows "temporary relief" from having to repay debt now, which has to be repaid in the future. However, the ability to sustainably repay and reduce debt in the future requires fiscal prudence now, in order to meet the future payments in a sustainable manner. Fiscal prudence, when combined with a "voluntary restructuring" has the massive benefit of sustainably reducing government's appetite for debt, resulting in a sustainable reduction in interest rates and the ability to grow out of debt. A "default" has the opposite consequences.

In summary, there is no scenario of "debt restructuring" under which Jamaica can get away with not being fiscally prudent. Further, the most viable form of "debt restructuring" is one where creditors willingly decide to share the burden by allowing enough room for fiscally prudent reforms to take place. Further, the only viable form of "restructuring" is one that is voluntary.

Towards a Credible Policy Solution

If Jamaica intends to credibly demonstrate a sustainable reduction in its debt ratio over the next three to five years, it will have to start by being fiscally prudent from today. However, markets and economic agents are unlikely to be impressed by promises that are unsupported by the track record of policy makers (past and present). Hence there is some merit in examining whether fiscal commitments should be supported by simple, easily verifiable "binding constraints / laws" or "rules" to increase credibility, promote fiscal discipline and increase transparency. Such a set-up would invariably reduce the occurrence of future "fiscal surprises" by expressly considering such liability scenarios well in advance of their occurrence, in order to satisfy the "binding constraints / laws" or "rules". In effect, this could be the "game-changer" that Jamaica so desperately needs to "grow out of debt".

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