The budget: Economic Stability and the Domestic Capital Market

The Government of Jamaica (GOJ) tabled the Estimate of Expenditure, the Fiscal Policy Paper (FPP) and the Medium-term Debt Strategy (MTDS) in mid-February in keeping with amendments to the Financial Administration and Audit (FAA) Act. At the macro level there is no surprise regarding the shift in the different line items in this year's budget and expected expenditure over the medium term. As we have argued via this platform, the tabling of a medium-term expenditure framework is in keeping with good governance. It covers multiple fiscal cycles and allows for better planning by the constituents within the economy who are impacted by the budget.

What is in the Budget?

The government plans to spend $803.2 billion which is relatively flat when compared to the expected expenditure for FY 2018/19 of $802.6 billion. Above the line spending, which excludes principal payment on debt, amounts to $629.4 billion and is $11.4 billion (1.9%) more than the programmed spending in the previous year. Included in this figure are recurrent and capital expenditure of $557.3 billion and $72.1 billion, respectively. Relative to the previous year, the outlay on recurrent expenditure is up $8.2 billion (2%) while spending on capital is up $3.3 billion (4.8%).

Below the line, the government will repay principal in the amount of $138.3 billion and expend $35.5 billion on 'Other' items, which include the recapitalization of the Bank of Jamaica.

To finance the budget the GOJ is relying on Revenue and Grants of $644.2 billion; loan inflows of 102.7 billion; and other inflows, which includes receipts from Petro Caribe Development Fund, of $18.4 billion. **Total inflows amounts to $765.4 billion which when compared to total outflows of $803.2 billion leaves an overall deficit of $37.8 billion.** A fiscal surplus (above the line revenue minus above the line expenditure) of $14.8 billion (0.7% of GDP) is programmed while a primary balance is expected at $150.9 billion (7% of GDP).

On the matter of the overall deficit, unlike FY 2018/19 where the GOJ carried over cash resources from the prior period to plug the hole, this sort of resource is not available to the government in FY 2019/20. There are several options that could be pursued to close the deficit, including shifting recapitalization of the BOJ over a longer period, increase borrowing by more than the stated amount in the FPP, sale of public assets not yet identified, or a combination of all of the above. Whichever option is pursued, it is highly likely that a supplementary budget will be tabled in the Parliament to address this discrepancy in the budget estimates.

Figure 1: Abridged Medium-term Budget

	2017/18	2018/19	2019/20	2020/21	2011/22	2022/23
Revenue & Grants	**560,773.6**	**623,864.2**	**644,205.3**	**685,593.2**	**729,867.9**	**776,588.3**
Tax Revenue	496,894.6	535,710.5	575710.5	612,185.9	651,910.3	693,337.7
Non Tax Revenue	53,249.9	73,654.6	59,608.5	64,109.8	68,174.7	72,976.5
Expenditure	**552,050.1**	**617,931.1**	**629,396.3**	**662,287.2**	**687,029.8**	**716,122.7**
Recurrent	505,244.0	549,128.0	557,285.7	585,737.5	605,123.8	628,385.6
Compensation of employees	193,283.5	200,480.6	210,442.8	226,395.1	242,236.4	259,481.7
Interest payment	135,181.0	136,204.7	136,125.4	138,083.4	130,564.8	124,965.3
Capital expenditure	46,806.1	68,803.1	72,110.6	76,549.7	81,906.0	87,737.1
Fiscal (deficit)/Surplus	**8,723.5**	**5,933.1**	**14,809.0**	**23,306.0**	**42,838.1**	**60,465.6**
Loan receipt	207,133.0	112,832.0	102,736.4	168,010.3	127,534.9	92,566.7
Amortisation	232,289.0	149,467.5	138,321.4	166,316.3	170,372.9	153,032.2
Net inflows/outflows other	(2,860.5)	(7,674.4)	(17,060.0)	(25,000.0)	-	-
Primary Palace	**143,904.5**	**142,137.8**	**150,934.4**	**161,389.4**	**173,402.9**	**185,430.9**
Overall Balance	**(19,294.1)**	**(38,376.8)**	**(37,836.0)**	-	-	-

Sources: MOF & P and JMMBIR

What does the Budget Communicate?

The fiscal space created through the lowering of the debt stock and by extension reduction in debt servicing cost is allowing the government to among other things increase expenditure on high priority projects across various ministries. Over the years the cost to service the debt and wages and salaries have crowded out capital spending. However, there is a paradigm shift as reflected in the amount that is programmed for capital spending this fiscal year; the outlay is $23.3 billion (54.1%) more than the projected expenditure in FY 2017/18. The higher spending on capital is a welcomed sign, as it complements other initiatives that are being pursued to push growth on an elevated and sustained path. Improving the country's dilapidated physical infrastructure will certainly assist towards this end.

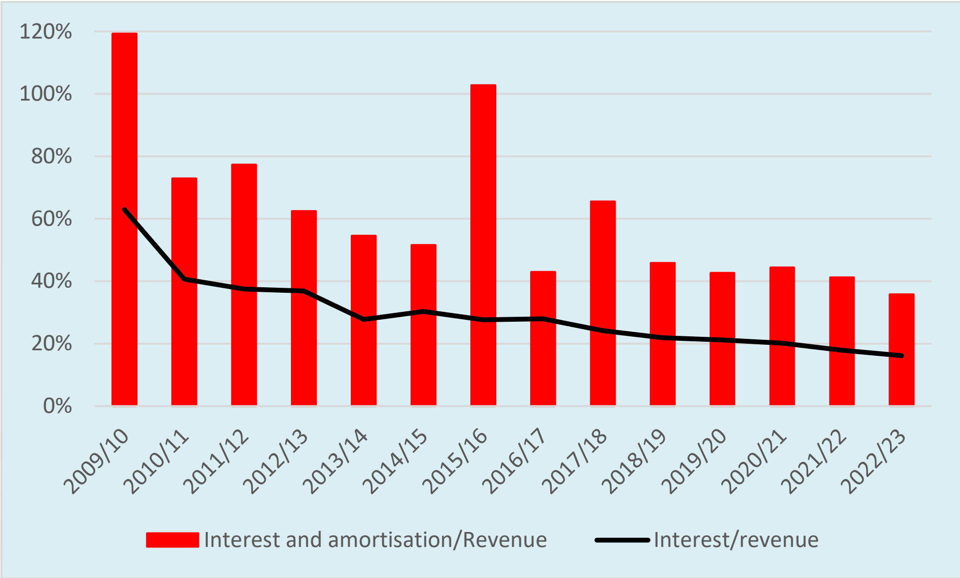
Sustained higher spending on capital in the future minimises the likelihood of the political directorate missing fiscal targets so as to gain political capital at the end of an election cycle. In the past accelerated spending on capital unmatched by increase in tax revenues has proven to be very disruptive to the smooth functioning of the economy, as it results in higher than expected fiscal deficits and inflation. This in turn should result in elevated levels of debt issuances to plug the budget deficit which crowd out private investments and stymie growth. In an era where a stable fiscal path and higher levels of capital spending are envisaged, the fiscal authority is in a good position to not "burst the budget" in order to pursue election objectives. As such, in the absence of shocks to the economy, we do not expect the actions of the past to be repeated in the future.

Debt

The GOJ advised that the total stock of public debt at end-December 2018 was $1,944.1 billion which was $2.4 billion (0.1%) higher than at end-March 2018. The debt stock is projected to increase to $1,961.0 billion (96.4% of GDP) by the end of the fiscal year. Debt to GDP is expected to continue to fall gradually to74% by end-March 2022/23. As per the Public Debt Act the authority has committed to reducing debt to GDP to 60% by the end of FY 2025/26.

Debt servicing costs

Figure 2: Debt service Costs



Source: MOF&P and JMMBIR

Over the past several years interest cost on the debt has fallen, particularly on the local currency side. The reduction reflects relatively benign external and domestic capital market conditions, as well as slow growth in the debt accumulation. Overall the debt portfolio is comprised of 32% variable rate (VR) debt – domestic debt, 37.7%; and external debt, 28.9%. Variable rate debt in the GOJ portfolio is reset at a lower interest rate with the fall in reference rates. LIBOR is the main reference rate used to re-price the international VR debt while domestic Treasury bill (T-bill) yields are used to re-price the local VR debt. Rate movements were mixed in 2018, T-bill yields declined by 200 basis points (bps) while the 3-month LIBOR increased on average 105 bps. Relative to 5 years ago LIBOR increased by 245 bps while T-bill yields declined by 620 bps. On a net basis the portfolio benefitted from the lower T-bill yields over the period.

It is likely that conditions will remain relatively accommodative in the capital markets for GOJ debt issuances. Slower expected real GDP growth in the global economy and low inflation expectation in the US may compel the Federal Reserve (Fed) to stay its policy rate increase in 2019. Likewise in Europe, slowing growth and concerns about Brexit, may influence the European Central Bank to stay any rate increase. As a result of expected overall market conditions, it is likely that LIBOR will remain relatively flat during the fiscal year. On the local side, subdued GOJ domestic issuances and accommodative monetary policy are likely to influence T-bill yields. Therefore yields are expected to remain relatively flat over the course of the fiscal year. If these conditions come to fruition then it is reasonable to expect that the debt service cost will fall in line with projections at the end of the fiscal year.

<u>Maturity Profile of the debt</u>

The size of the debt relative to GDP is falling, but there are concerns regarding bunching in the portfolio, that is the proportion of debt falling due over a short time horizon. The proportion of debt falling due in 1 year is over 10% while there is a sizeable portion that becomes due within the next 5 years. For now market conditions are relatively favourable when compared to 2008-09 (external and domestic) and 2013 (domestic). However, sharp negative changes in market conditions could put upward pressure on interest rates and consequently GOJ debt service cost. Under extreme conditions the GOJ may find it extremely challenging to raise the requisite quantum of debt in a given fiscal cycle, particularly in the external capital market. As such due consideration should be given to extending the maturity profile of new issuances so as to reduce the refinancing risk that is inherent in the debt portfolio.

<u>GOJ operation and the Domestic Capital Market</u>

Even though the GOJ is still active in the domestic capital market, the proportion of issuances in relation to the market size has fallen significantly. This has much to do with the authority making hard decisions in previous years and sticking with the outcomes. The decisions then which included among other things reducing the fiscal deficit and generating a primary balance of 7% of GDP or more. Over the medium-term the GOJ plans to roll approximately 78% of the overall debt, of which 87% will be done on the domestic side. Assuming no shift in debt operation from the programmed path, at least \$20 billion in domestic maturities will flow back to the local capital market in FY 2019/20 with a further \$39 billion expected in FY 2022/23. This will create further room for corporate debt issuances for retooling and/or refinancing. We however hasten to caution that the quantum of corporate issuances may not be on the same scale as GOJ issuances in the past, and that the speed of increase is heavily linked to the pace of economic growth. Therefore, a reversion to a growth path that is lower than envisaged over the medium-term could have a negative effect on the local capital market.

Opinion

We have taken the opportunity to assess the budget from a macro perspective and look at its impact on engendering economic stability and domestic capital market development. In our view the budget is fairly balanced and with a greater thrust by the GOJ on capital spending and continued reduction in the debt, the country and its citizens stand to benefit. Improvements in infrastructure can engender higher real economic growth.

Reductions in the public debt trajectory and lower levels of GOJ debt issuances have created an environment that "crowds-in" corporate investments. This coupled with accommodative monetary policy has rebounded to the benefit of the productive sector, as we are seeing increased levels of domestic capital market issuances to refinance loans, and in more recent times for retooling operations. If domestic economic conditions remain accommodative, it is fair to assume that the local capital market will remain buoyant and the level of investments that will flow from it will help to drive real and sustainable GDP growth.

APPENDIX

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