Recent Developments:

• Economic growth increased by 2.8% in 2013, driven by sustained activity in financial services, telecommunications, and construction. GDP growth was 2.9% in the final quarter of 2013, as the economic recovery remained subdued.

• After reaching 5.6% in 2013, year-on-year inflation dropped to just above 3% for the first third of 2014, as the impact of the fuel price liberalization subsided.

• After resuming in late 2013, gas inflows from Egypt were once again interrupted in January of this year. This together with a growing number of Syrian refugees, continues to place pressure on the country’s fiscal and external accounts.

• The budget deficit narrowed in 2013 to 5.5% of GDP, including grants, compared to a deficit of 8.3% of GDP in 2012.

• In 2013, current expenditures fell year-on-year by JD 152 million, the first drop since 1999, as a result of removal of fuel and other subsidies.

• According to the 2014 budget, the central government deficit is projected to narrow further to around 4.3% of GDP this year. Although for the first quarter of this year, the fiscal deficit increased by JD 116 million compared to the same period last year.

• Meanwhile, if we look at the fiscal deficit excluding grants, we find that the deficit in 2013 has also narrowed to 8.2% of GDP from 9.8% in 2012. However, the budget deficit remained significant at JD 1.9 billion during 2013, highlighting the country’s continued dependence on volatile foreign grants.

• Net public debt reached around JD 19.1 billion by the end of 2013, around 79.6% of 2013 GDP, increasing by around JD 2,516 million during the year. External debt increased by around JD 2,302 million during 2013, while domestic debt increased by around JD 214 million for the same period. Net public debt is expected to increase to around 82% of GDP in 2014.

• The government has continued to depend on cheap external funding, with the government expected to issue another U.S. guaranteed government bond ($1 billion) in the coming weeks. The Eurobond will help provide cheap funding to the government and boost FX reserves, while also boosting local excess liquidity.
• The Central Bank of Jordan (CBJ) has restored trust and rebuilt its international reserves buffer to about 6 months of imports as of March 2014, currently at an all-time high of $13 billion.

• In 2013, the current account deficit declined to nearly 10% of GDP, dropping by 5% of GDP compared to 2012 in view of lower energy imports, higher transfers and private receipts. But risks to the current account remain high in 2014, mostly due to the Syrian conflict and further possible disruptions in energy imports.

• Jordan’s Central Bank cut its main benchmark rates by 25 basis points in January 2014. The central bank seems to press ahead with its expansionary policy, after it previously cut rates by a similar 25bp in October and August 2013.

• Government bond yields plunged significantly since the start of 2013, supported by high coverage ratios, at times above 400%. Yields have continued to fall in the first months of 2014, however stabilization was evident in the latest auctions, as government bond yields have ticked up slightly since the beginning of April this year.

• Currently, upward and downward interest rate risks are nearly balanced, and the outlook for interest rates in the second half of 2014 is stable, with a small room for another CBJ cut by 25 basis points.
Economic growth expected to improve in 2014, but remain subdued

Jordan’s real GDP grew moderately by 2.8% in 2013, slightly higher than 2012, when the economy expanded by 2.7%. But economic activity remains subdued, with growth below its 2005-2009 average of 7.4%.

Growth was driven by sustained activity in financial services, telecommunications, and construction.

The construction sector grew by 8.7% in 2013, following negative growth levels since the beginning of the 2009 financial crisis. Growth was driven by a surge in demand coming from Syrian refugees, high workers’ remittances, increased capital expenditure in the form of capital projects funded by the GCC, and a better political outlook.

Looking ahead, the slowdown in the number of new Syrian refugees entering the Kingdom this year along with austerity measures weighing on the economy could bring down growth levels in this sector. However, the downside risks are expected to be offset by an increase in capital expenditures, higher workers’ remittances, and a more stable political outlook compared to last year. For the first few months of 2014, figures have shown that building permits have declined, which could indicate that the momentum of construction activities may slow down compared to 2013.

Meanwhile, manufacturing and tourism seemed to stall, and mining and quarrying contracted by around 11%, hurt by global competition and a drop in exports.

Growth in the tourism sector, which is one of the main sources of foreign currency income for the kingdom, has rebounded since 2011, but seems to have stalled in 2013 as risks arising from geopolitical instability continue to place pressure on the sector. Tourism revenues have increased by 1.4% in 2013, but the number of visitors continued to drop in 2013, down by 20% between 2011 and 2013.

Developments in the first quarter of this year point to recovery in the tourism sector. Jordan’s tourism sector experienced a rise in revenues and number of visitors in the first three months of 2014, compared to the same period a year earlier. Tourism revenues rose by 11.1%, exceeding $1 billion in the first quarter, according to the Ministry of Tourism.

On the other hand, while the mining sector constitutes a small percentage of GDP composition, it was one of the worst performing sectors in 2013, unlike previous years. The mining sector contracted in 2013 mainly as a result of a drop in the exports of phosphates and potash due to high global competition and a slowdown of global demand particularly from emerging markets.
Emerging markets suffered from hot money outflows and depreciating currencies, following the US Federal Reserve’s decision to scale back their quantitative easing, which fuelled further drops in demand in the second half of 2013.

Nevertheless, exports in the mining sector, especially phosphate, have begun to pick up in the first two months of 2014, which may indicate better growth levels for the sector in 2014.

Given the large reserves of potash and phosphate that Jordan has, the sector is supposed to perform better, and generate more income for the country.

Overall, growth is expected to accelerate in 2014 to around 3.5%, likely to be sustained by more efficient capital spending and a more stable political outlook this year. However, growth levels remain lower than pre-2010 trends owing to persistent fiscal challenges and political uncertainty.

The country remains vulnerable to potential gas flow disruptions from Egypt and pressures arising from the Syrian crisis. The large influx of refugees into Jordan has put significant pressure on labor, housing markets, and external balances; stressing the country’s resources.

Nevertheless, the economic improvement in the Gulf economies will likely spillover to Jordan in the coming years, in terms of more foreign investment and new job opportunities. This will help support Jordan’s economic growth and help tackle its high unemployment rate.

Although the authorities have implemented structural reforms to develop the private sector, unemployment remains persistently high, averaging around 13% over the past decade. Unofficial figures place the unemployment rate much higher around 20-25%.

Another challenge for the authorities in this area, is the demographic window Jordan is experiencing, with an accelerating number of Jordanians entering the age of work, while participation rates for both men and women are yet low compared to peer economies.

**Inflation expected to ease as effect of fuel price liberalization fades**

Average annual inflation increased to 5.6% in 2013 due to the impact of the fuel price liberalization in late 2012. However in the last few months of 2013, this impact subsided and inflation trended downwards; year-on-year inflation dropped to 3.1% in March of this year.
Rents remains one of the main contributors to CPI with an increase of 8%, most likely due to an increase in demand from Syrian refugees. Other main contributors include fruits and vegetable (7%), clothes (8.2%), education (6%) and tobacco (12%).

On the other hand, prices of fuel and electricity were down around 0.2%; no longer a contributing factor for rising inflation.

So far this year, the country has benefitted from lower international oil prices, which has helped to keep inflation contained after the recent reductions in subsidies. However, the country now remains particularly vulnerable to an upsurge in commodity prices.

**Jordan’s weakened fiscal metrics**

The government’s budget deficit has narrowed over the past year from 8.3% of GDP in 2012 to 5.5% in 2013. The improvement was mostly due to a surge in grants compared to the previous year, and implemented revenue enhancing measures; especially increases in sales-tax. Moreover, expenditure curbing measures, especially the removal of fuel and other subsidies, has led to the first drop since 1999 in current expenditures, by JD 154 million.

Meanwhile, capital expenditure increased, funded by GCC developmental grants. However, capital spending of developmental projects in 2013 was somewhat inefficient, as around 60-70% of earmarked GCC developmental grants were utilized. But this year, the figure is expected to be higher due to better political stability and the early approval of the 2014 budget law by parliament.

Overall, the structure of public finances remains relatively weak, as the government remains dependent on potentially volatile donor support to finance more than a third of the budget deficit.

Dependence on foreign grants increased to around 3.6% of GDP in 2013, and is expected to increase to 4.4% in 2014. This mean that a shortfall in the expected grants would add pressure on an already fragile public finances structure.

The budget deficit, excluding foreign grants, remained significant at JD 1.9 billion or 8.2% of GDP in 2013, even though it narrowed from 9.8% of GDP in 2012.

Moreover, while current expenditures decreased in 2013, expenditures remain high and are expected to increase in 2014 despite the reversal in subsidies. According to data from the General Budget Department, the coverage of current revenues to current expenditures is expected to end-2013 at around 85%, likely to be maintained in 2014, which remains below international standards of 100%.
Meanwhile, as Jordan remains highly energy dependent, the gas supply interruptions from Egypt has continued to place pressure on the National Electric Power Company - underscoring the country’s ongoing vulnerability to commodity and external political shocks.

It is noteworthy that the gross deficit, after adding public entities’ deficit, for 2013 reached JD 2.6 billion or 10.7% of GDP after grants, and JD 3.2 billion or 13.4% of GDP before grants.

The adoption of revenue measures and increases in electricity tariffs for most economic sectors was expected to ensure that the 2014 Budget and NEPCO’s losses are consistent with the authorities objectives and the IMF program. However, with the delay in the revised income tax reform law, this is likely to add further pressure on the governemnt to find new revenue enhancing measures.

Syrian refugees, who constituted about 8% of Jordan’s population according to offical estimates at the end of 2013, have also put Jordan’s fiscal account under substantial pressures.

Meanwhile, financing needs for 2014, are estimated at around 33% of GDP, according to the IMF’s fiscal monitor, which is considered high by international standards. This is likely to weigh further on the government’s fiscal metrics.

For this year, the budget’s deficit is likely to come down to around 4.3% of GDP, after grants, as revenues measures are expected to help finance higher capital spending, at least according to the government 2014 budget law.

However, figures for the first quarter of 2014, showed that the budget had deteriorated resulting in a wider deficit, by JD 116 million, compared to the same period last year. Moreover, excluding foreign grants, the budget deficit is expected to increase to 8.7% of GDP in 2014.

**Upward trend in government debt**

Public debt is likely to increase further from an already high level. Net public debt, the government’s preferred measure for public debt, reached around JD 19.1 billion by the end of 2013, around 79.6% of 2013 GDP, increasing by around JD 2.5 billion during the year.

According to the governemnt’s 2014 budget law, net public debt is expected to increase by JD 1.7 billion in 2014, to reach around 82% of GDP.

However, gross public debt increased to a much higher 86% of GDP by the end of 2013, and is expected to reach 90% in 2014, according to IMF estimates.
Despite its relatively large size, the structure of Jordan’s government debt is favorable. In 2013, around 35% of the gross debt was external with low servicing costs and long maturities, but this ratio has increased from 29% in the previous year.

Nevertheless, it seems that the government continues to shift some of its borrowing towards external debt, taking advantage of low borrowing costs, while at the same time boosting the country’s foreign currency reserves.

External debt increased by JD 2,302 million during 2013, while domestic debt increased by JD 214 million for the same period. The increase in external debt was a reflection of a $1.25 billion U.S. guaranteed Eurobond and two $500 million USD denominated local government bonds.

This year, according to the 2014 Budget Law and CAB estimates, external debt is expected to increase by around JD 800 million while domestic debt is expected to increase by around JD 885 million, which is much lower than the JD 2.7 billion in 2012.

A new $1 billion Eurobond is expected to be issued in June of this year, also guaranteed by the U.S. Treasury, for a duration of 5-years.

In terms of domestic debt, the Social Security Investment Fund seemed to be an active player in 2013. According to SSIF data, a sizable portion of its 2013 investments was directed towards internal government bonds. This trend, if not repeated, may place some upward pressure on government bonds’ yields and debt service in 2014.

**External positions will remain under pressure**

Jordan’s external position continues to rely on large and volatile foreign investment inflows, recently in the form of aid or loans from foreign governments, to finance a large, albeit decreasing chronic current account deficit.

The current account deficit dropped to around 10% of GDP in 2013, down from 15.2% in 2012, helped by lower energy imports, sizable grants from the GCC, and private transfers.

Meanwhile, despite a JD 545 million (12%) drop in oil bill during 2013, accounting for 25% of the country’s imports, the trade deficit increased by around 9%, as a result of increased domestic demand likely driven by the influx of Syrian refugees, and the continued volatility in the Egyptian gas supply.

Exports deteriorated in 2013, as the increase in energy costs likely affected the competitiveness of Jordan’s exports, combined with a slowdown of global demand.
Meanwhile, recent negotiations with Iraq have opened the doors for bilateral relations with the country, which will help foster growth, create jobs, and increase government revenues – exports to Iraq were up 17.5% in the first quarter of this year. The construction of the proposed oil pipe between Basra and Aqaba is expected to reduce the oil import bill through preferential prices and bring down transportation costs.

During the first quarter of 2014, the trade deficit narrowed by around 4.5%, compared to the same period in 2013, as exports seem to have rebounded. However, political instability in the region could disrupt trading routes again.

On the other hand, foreign currency reserves had recovered to $12 billion, above 6 months of imports, by the end of 2013, as confidence was renewed in the Jordanian Dinar. Currently FX reserve levels are at an all time high of $13 billion, or 6.5 months of imports on the back of stronger external support especially from the GCC, lower energy imports, and private receipts. Moreover, the successful issuance of two USD denominated domestic bonds, the US guaranteed Eurobond, and reverse dollarization trends also fuelled the surge in FX reserves.

Overall, Jordan is heavily exposed to spillovers from Syria, and an escalation of the civil war could lead to a further inflow of refugees, adding to the pressure on public finances and external balances. Moreover, a continued disruption in gas supplies from Egypt would weaken the current account and increase NEPCO losses (by as much as 2% of GDP in 2014).

Other risks stem from regional uncertainties that could affect FDI and private sector confidence, creating challenges in attracting capital flows, and from global spillovers such as an increase in US interest rates or a further drop in capital inflows into the region as a result of the Fed’s gradual withdrawal of liquidity injections.

**CBJ cuts rates and interest rates trended downwards**

Most monetary development were positive in the first few months of the year, due to lower dollarizations levels, better excess liquidity levels, lower market rates on government bonds, and record high FX reserves.

As a result, the Central Bank of Jordan cut its benchmark lending rates by 25 basis points on January 20, after previously cutting rates by a similar 25bp in October and August 2013; focusing on stimulating sluggish growth to shield the economic recovery from the aftermath of new rounds of austerity.

During the first quarter of 2014, JD deposits have increased by JD 1,070 million to reach around JD 22.1 billion at licensed banks, following a JD 3.3 billion increase in 2013. On the other hand,
foreign currency deposits fell by approximately $136 million for the same period to reach $9.1 billion, after they had dropped by $942 million in 2013.

Meanwhile, credit to private sector fell by JD 255 million in the first quarter of the year, a drop of 1.4%. This unusual drop is mainly a result of the mandatory redemption of Islamic Banks’ Murabaha and Swap contracts, as such transactions were classified by the Central Bank as credit facilities.

Despite withdrawing about 50% of CBJ stimulus liquidity in the first four months of 2014, excess liquidity levels were maintained at JD 3.2 billion, after increasing by more than JD 1 billion in 2013 – reflecting lower dollarization and lower current account deficit.

Government bond yields plunged significantly since the start of 2013, supported by high coverage ratios, at times above 400%. However, the drop in yields started to stabilize in March of this year, and ticked up during April.

This is likely a correction of the significant drop in yields that started in 2013. With domestic borrowing increasing and some active market players (such as the Social Security Investment Fund) unlikely to match 2013’s investments this year, this may have also supported the slight tick up in government yields as of April.

Meanwhile, customer deposit rates seemed to be less elastic to the interest rate cuts by the central bank in 2013. The reason behind this was likely due to the extraordinary drop in deposits in 2012, by JD 1.4 billion, which led to an accumulative liquidity gap since credit facilities grew by around 10% in 2012.

This left market response to lower benchmark rates slow and gradual. Interest rates continued to trend upwards through 2013, despite two consecutive cuts by 25bp to benchmark rates.

However, as JOD deposits grow, the liquidity gap will likely be covered in the short-term, adding pressure on banks to offer lower rates in response to CBJ rate cuts. During the first quarter of 2014, customer deposit rates have been trending downwards, falling by around 13 basis points.

On the other hand, JODIBOR rates have been more responsive to benchmark interest rate movements. This is important because interest rates on retail loans are linked to a variety of benchmark instruments, including JODIBOR rates.

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1 In order to tackle the drop in excess liquidity witnessed in 2012, the Central Bank of Jordan introduced a number of monetary measures to help push excess liquidity levels back up, including weekly and monthly Repos, and USD/JOD swaps. As monetary indicators improved in 2013, the CBJ began to withdraw those measures on a gradual basis.
Following the latest 25 basis point rate cut by the central bank of Jordan on January 20, 6-month JODIBOR rates fell to 5.686%, a drop of around 23bp, the largest drop so far. Currently, 6-month JODIBOR rates are at 5.67%, as of end of May.

**Outlook for interest rates:**

Overall, upward and downward pressures are currently balanced, with a stable outlook for interest rates in the second half of the year, but risks will be tilted slightly more to the downside.

The government seems likely to cover most of its domestic debt needs for 2014 in the first half of the year. Net domestic debt increased to around JD 600 million for the first third of the year, according to raw calculations by CAB, which is almost close to the government’s target for the year. This significant increase despite the inflow of the Eurobond received last year is likely an indication that the government is taking advantage of currently lower interest rates.

This coupled with the likely issuance of the $1 billion U.S. guaranteed Eurobond in June, and the continued increase in JOD deposits in the banking system, is expected to stabilize interest rates at current low levels with some downward pressures in the second half of the year.

Accordingly, the Central Bank might have room for another 25 basis points interest rate cut in the second half of the year.
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