Research Department

Jordan Economic Report

November 11, 2014

Major Developments:

- **Economic growth remained subdued in the first half of the year. GDP grew by 2.8% in the second quarter of this year, down from 3.2% in the first quarter, indicating that high uncertainty is still weighing on economic activities.**

- **Annual inflation remained just above 3% throughout the year, as the impact of the fuel price liberalization faded. This year, rents was the main contributor to inflation, as rent prices increased due to the increased demand from Syrian refugees. Looking ahead, continued low growth rates and low energy prices are expected to keep inflation rates in check.**

- **After resuming in late 2013, gas inflows from Egypt were once again interrupted in January of this year, and remained volatile so far this year. This, together with a growing number of Syrian refugees, continue to place pressure on the country's fiscal and external accounts.**

- **According to the 2014 budget, the central government deficit is projected to narrow to around 4.3% of GDP this year. However, for the first eight months of this year, the fiscal deficit increased by JD 91 million compared to the same period last year.**

- **Meanwhile, the fiscal deficit excluding grants, was projected to widen according to the 2014 budget to around JD 2.3 billion or 8.7% of GDP, highlighting the country's continued dependence on volatile foreign grants.**

- **One main development in 2014 is an unrepeatable JD 300 million increase in revenues, resulting from licenses for telecom and electricity companies. While this development helped to impede further widening in the fiscal deficit, the government will need to come up with new measures for next year if it plans to reduce its deficit as projected in its budget law for the year 2015.**

- **Public debt continues to trend upwards. For the first eight months of the year, net public debt reached JD 20.4 billion, around 79.7% of 2014 GDP. Net public debt is expected to increase to around 83% of GDP in 2014.**

- **Public debt seems to be on a steaper path when we look the gross public debt. In the first 8 months of the year, gross public debt increased by JD 1.7 billion to JD 22.4 billion or around 86.4% of GDP.**

- **The government has continued to depend on cheap external funding, with the government successfully issuing another U.S. guaranteed government bond ($1 billion) in June 2014. The Eurobond helped provide cheap funding to the government and boosted FX reserves, while also boosting local excess liquidity.**

- **According to official forecasts, domestic borrowing seems to be increasing over the coming years. However, the expected emergence of the local Sukuk market early next year will likely bring some relief to the government, easing pressures on interest rates.**

- **The Central Bank of Jordan (CBJ) continued to restore trust, rebuilding its international reserves buffer to about 7 months of imports as of August 2014, currently at an all-time high of $14.5 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. Nevertheless, risks to the current account remain high in 2014, mostly due to the significant population growth, and continued disruptions in energy imports. The IMF expects the current account deficit to register 10% of GDP in 2014, unchanged from 2013.**

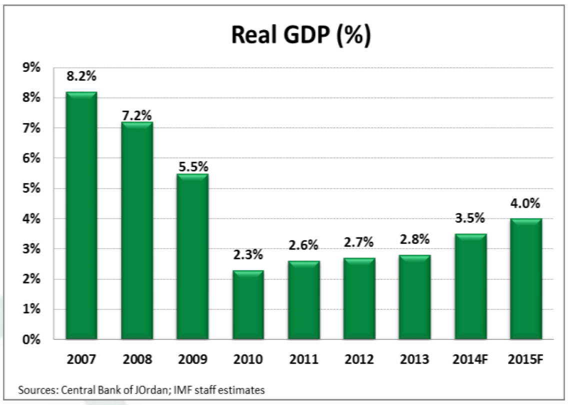
- **Jordan's Central Bank cut its main benchmark rates by 50 basis points in June 2014. The central bank seems to press ahead with its expansionary policy and trust in the economy and political stability, after it previously cut rates by 25bp in January 2014, and 50bp in 2013.**

- **Government bond yields remained low but see-sawed throughout the year. Yields have continued to fall after the latest CBJ rate cut, however stabilization was evident in the latest auctions, as government bond yields have ticked up since the beginning of October this year.**

- **The recent drop in oil prices is likely to bring some relief to the country's external balances. According to recent official statements, the government expects that a 20% drop in oil prices could lead to a drop in the current account deficit by around JD 800 million.**

- **Interest rates are likely to remain at current low levels over the next few months. Nevertheless, we believe that risks to the interest rate outlook are tilted to the upside and expect rates to increase particularly towards the end of 2015.**

Economic growth expected to improve in 2014, but remain subdued



Jordan's GDP grew by 2.8% in Q2 of 2014, down from 3.2% in Q1 - the highest quarterly growth figure since Q4 2010 - while growth expectations for the year are around 3.5%. However, growth still remains low compared to a 7.4% average throughout the 2005-2009 periods, and below the 6.1% needed to absorb the fast increasing new entrants to the labor market.

Growth in the second quarter was driven by the utilities sector, wholesale and retail trade, and tourism, while the agricultural sector was the only sector to show a contraction over the same time period.

The utilities sector grew by 11.2% when compared to Q2 of 2013, and is likely due to large conventional infrastructure projects and some unconventional renewable energy projects, especially as foreign institutions and NGOs are interested in supporting the energy sector in the Kingdom. Growth in the utilities sector could also be driven by the substantial growth in the population which has generated excessive demand for basic needs of water and electricity.

The wholesale and retail trade sector grew by 7.3% over the same time period, as the number of Syrian refugees who have entered the country increase consumption activity, while the sector was also supported by an increase in tourism activity.

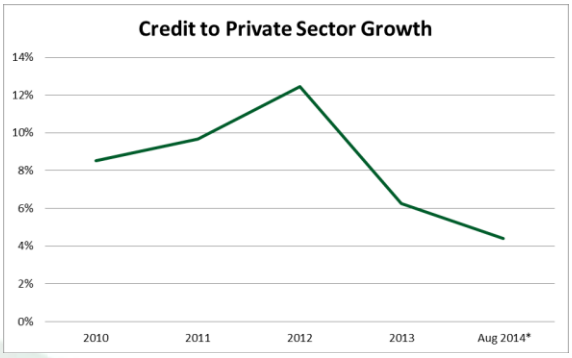
The tourism sector registered a 5.5% growth level when compared to the second quarter of 2013, likely driven by higher tourism income and accelerating investment levels. Data released by the Ministry of Tourism show that the numbers of visitors to the Kingdom have dropped, especially same-day visitors, yet tourism receipts, one of the main sources of foreign currency in the country, are up by 14% during the first half of the year. The data seems to indicate the quality of touristic activities are improving.

The tourism sector's potential continues to be adversely affected by the regional political instability, especially with the recent developments in the region. However, the political stability in Jordan has helped offsetting that adverse effect, mainly by attracting new Arab tourists to the country.

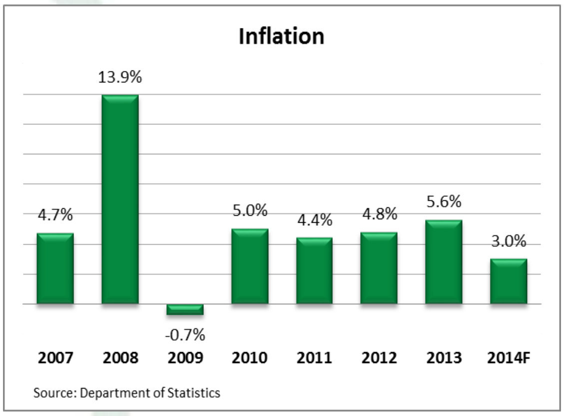
The mining sector rebounded during the first half of the year, after contracting by around 11% in 2013 as a result of a drop in potash and phosphate exports due to high international competition and slowdown of global demand. The sector grew by 4.3% in the first half of 2014, as phosphate exports picked up marginally, while potash exports continued to decline in 2014, following already low levels in 2013.

Prospects for the mining sector this year are generally better when compared to last year; exports have rebounded marginally, while other sector specific indicators have shown an improvement.

The construction sector registered a 3.2% growth level, well below the quarterly average growth of 8.7% in 2013, as effect of Syrian refugees influx has started to fade. However, growth in the sector is still being driven by significant population growth and continued growing capital expenditures in 2014, particularly development projects. Sector-specific indicators show that area licensed for construction has dropped so far in 2014, in line with the recent slowdown in the sector's growth levels.



Source: Central Bank of Jordan; *CAB estimates



Overall, growth is expected to register 3.5% in 2014, driven by higher capital expenditures and better political stability. However, growth still remains lower than pre-2010 trends, mainly due to ongoing political instability and weakened fiscal metrics.

Weak growth has weighed on unemployment levels, which registered 12% in the second quarter of this year, while unofficial estimates place unemployment at around 25%. Unemployment continues to be strained due to abnormal growth in the population and a growing labor force resulting from an accelerating number of Jordanians entering the age of work. The unemployment is also driven by the structural mismatch between the labor force available and the kind of jobs generated by the economy. The IMF estimates Jordan will need to increase employment by an estimated 403,000 full-time positions over 2013-2020 to absorb new entrants in the labor force.

Meanwhile, the country remains vulnerable to external pressures arising from a disruption in Egyptian gas and a slowdown in foreign aid, placing stress on fiscal balances. In addition, the Syrian crisis is still placing pressure on Jordan's labor market, while also weighing on its resources and infrastructure. High uncertainty is expected to continue limiting growth levels and foreign investment given the regional political climate. This has resulted in lower private sector credit growth, which grew 4.4% up to August of this year, according to CAB estimates, well below growth levels witnessed in previous years.

Inflation expected to remain subdued through 2015

Average annual inflation remained around the 3% line and registered 3.1% during the first three quarters of the year. Annual inflation is expected to end the year at around 3%, compared to 5.6% the previous year, as the impact of the fuel price liberalization in late 2012 subsided towards the last few months of 2013.

Rents still are one of the main contributors to inflation with an increase of 7.1% over the same time period, and the increase stems from continued demand from Syrian refugees. Other contributors to

CPI are tobacco (13.7%), clothes (10.3%), education (5.2%), and transportation (3.0%). On the other hand, telecommunications price dropped (0.2%), vegetable prices dropped (1.4%), and personal care price dropped (0.8%).

Looking ahead, the recent significant decrease in international oil prices will place downward pressure and help contain inflation over the short-term. Meanwhile, continued subdued economic growth of around 3.5% is expected to keep inflation levels low. The IMF expects inflation to drop further in 2015, to around 2.6%.

JD Million	Jan - Aug 2014	Jan - Aug 2013
Total Revenues and Grants	**4,378.3**	**3,888.2**
Domestic Revenue	3,909.2	3,363.6
Foreign Grants	469.1	524.6
Total Expenditures	**4,969.3**	**4,380.6**
Current Expenditures	4,415.4	3,917.7
Capital Expenditures	553.9	462.9
Fiscal Deficit/Surplus Including Grants	**-591.0**	**-492.4**
Fiscal Deficit/Surplus Excluding Grants	**-1,060.1**	**-1,017.0**

Source: Ministry of Finance

Jordan's weakened fiscal metrics

One of the main challenges facing the Jordanian economy is its high and rising debt levels and continued fiscal imbalances.

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, especially GCC grants earmarked for developmental projects, 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 in current expenditures since 1999, by JD 154 million.

However, the country's fiscal account is likely to remain under pressure due to the continued pressures to maintain social spending, high energy prices and the added strains from the Syrian refugee influx.

According to the preliminary government budget figures released by the Jordanian Ministry of Finance for Aug 2014, the fiscal deficit deteriorated in the first eight months of this year compared to the previous year. Jordan's fiscal deficit increased by 20% in the January – August period to reach JD 591 million compared to JD 492 million for the same period of 2013.

The JD 99 million increase in the budget deficit was a result of a JD 589 million increase in total expenditure which offset a JD 490 million increase in total revenues and grants.

Foreign grants decreased by JD 56 million to JD 469 million in the first eight months of the year, compared to the same period last year. The level of foreign grants committed had been somewhat stagnant over the past few months, however, foreign grants increased by JD 139 million in August and are likely to increase further in the coming months.

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.

Gross fiscal deficit including public entities:

JD Million	2012	2013	2014 Budget
Fiscal Deficit Including Grants	1,824	1,307	1,114
Percent of GDP	8.3%	5.5%	4.3%
Fiscal Deficit Excluding Grants	2,151	1,946	2,265
Percent of GDP	9.8%	8.2%	8.7%
Fiscal deficit including public entities, including grants	3,424.1	2,564.2	2,233.7
Percent of GDP	15.6%	10.7%	8.6%
Fiscal deficit including public entities, excluding grants	3,751.3	3,203.3	3,384.7
Percent of GDP	17.0%	13.4%	13.1%

Source: Ministry of Finance, General Budget Department, CAB calculation

The budget deficit in the first 8 months of 2014 widened despite the significant increase in revenues. Domestic revenues increased by around 13% for the same period, covering 88.5% of current expenditures up from 85.9% for the same period the previous year.

One of the main developments was a 28% increase in non-taxable revenues mainly resulting from gains of around JD 300 million due to licenses for telecom and electricity companies. However, this increase is unlikely to be repeated next year, which means the government will have to come up with different measures to increase domestic revenues.

Meanwhile, sluggish growth in foreign grants compared to last year, remains one of the main reasons for the deterioration of the fiscal balance, which is currently underperforming official forecast for the 2014 budget. The fiscal deficit including grants is expected to narrow compared to the previous year, to a deficit of JD1.1 billion or 4.3% of GDP.

Looking at the fiscal balance excluding grants, we find that the deficit widened to JD 1,060 million in the first eight months of the year; an increase of around 4% or JD 43 million. The budget deficit excluding foreign grants, is expected to increase to 8.7% of GDP in 2014.

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 shocks.

It is noteworthy that the gross deficit, after adding public entities' deficit, for 2014 is expected to reach JD 2.2 billion or 8.6% of GDP after grants, and JD 3.4 billion or 13.1 % of GDP before grants.

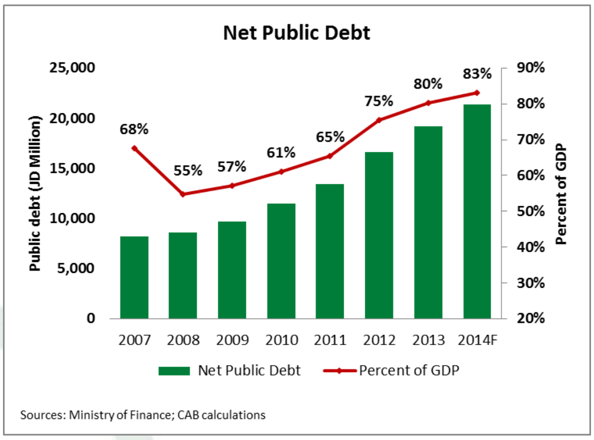
The adoption of revenue measures and increases in electricity tariffs for most economic sectors was expected to ensure that the Budget and NEPCO's losses are consistent with the authorities objectives and the IMF program. However, with the delay in the revised income tax reform law, this is likely to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

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

Meanwhile, the recent drop in oil prices could ease some pressure on the government finances. If the drop in oil prices is sustained, then Jordan can finally get some relief for its JD 4 billion ($5.6 billion) oil import bill, and its expected annual $1.4 billion NEPCO losses.

Upward trend in government debt

The country remains on an upward trending public debt path, as the public net debt-to-GDP (the government's preferred debt ratio) is projected to increase to 86.1% in 2014, according to IMF estimates, from 75.5% in 2012.



While the government's estimates place public debt at a much lower 83% by the end of 2014, the accumulation of debt expected in the next couple of years seems to be very significant.

Preliminary figures by the Ministry of Finance stated that net public debt reached around JD 20.4 billion by the end of August of this year, around 79.7% of 2014 GDP; increasing by around JD 1,300 million in the first eight months of the year.

External debt increased by around JD 1,067 million to reach 32.4% of 2014 GDP, mostly due to the successful issuance by the government of the $1 billion U.S. guaranteed Eurobond. Net domestic debt increased by around JD 232 million for the same period, to reach 49.7% of GDP, as the government shifted borrowing towards external markets.

However, looking at gross domestic debt, the picture becomes somewhat bleaker. In the first 8 months of the year, gross public debt increased by JD 1.7 billion, to JD 22.4 billion or around 86.4% of GDP.

Moreover, arrears to related government entities and private sector are still significant and there seems to be no major improvement in clearing them, adding pressure on public finances.

Meanwhile, sources of external funding are becoming limited especially in view of high payments and redemptions, which indicates that the government will likely face challenges to borrow from external markets in the next couple of years, placing extra pressure on local liquidity and upward pressure on the interest rate outlook.

Despite the rising public debt, the structure of Jordan's government debt is becoming more favorable. In 2013, around 35% of gross debt was external debt with low servicing cost and long maturities, and throughout 2014, the government took advantage of low borrowing costs auctioning around JD 1.8 billion in 5-year bonds, around 35% of all bonds auctioned this year. This strategy is expected to reduce the refinancing risk of the government's local debt.

Debt interest payments are projected to decrease by JD 13 million next year, compared to a JD 300 million increase for 2014, according to the preliminary 2015 Budget Law, mainly due to lower interest rates in the local bonds' market.

Moreover, the expected emergence of the Sukuk market in 2015, should ease some pressure on domestic borrowing, which could ease upside pressure on the interest rate outlook.

External positions remain under pressure

Jordan's external position continues to be strained by a growing import bill, lower capital inflows and public transfers. The current account deficit grew by around 97% during the first half of this year when compared to the same time period last year, indicating the slowdown in large and volatile foreign support from foreign government to help finance the current account deficit.

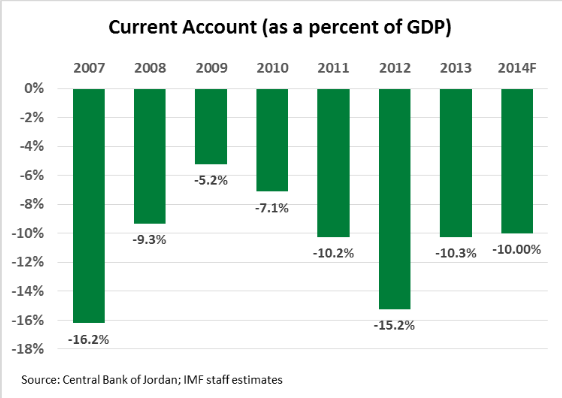
The current account deficit had dropped to around 10.3% of GDP in 2013 and the IMF expects the deficit to register 10.0% in 2014 as well. However, for the first half of the year, the current account seems to have deteriorated, increasing to around 10.0% as a percent of GDP, up from 5.4% for the same period in 2013, according to central bank figures.

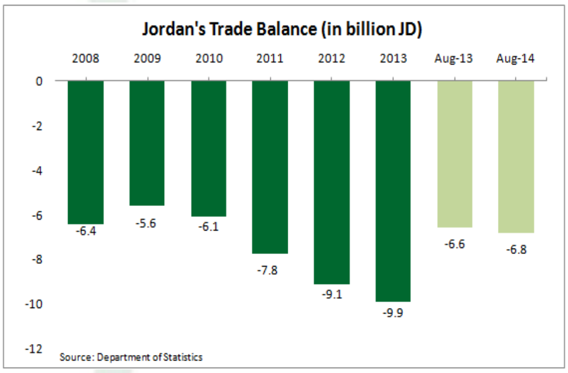
Nevertheless, the recent drop in oil prices is likely to bring some relief to the country's external balances. According to recent official comments, the government expects that a 20% drop in oil prices could lead to a drop in the current account deficit by around JD 800 million.

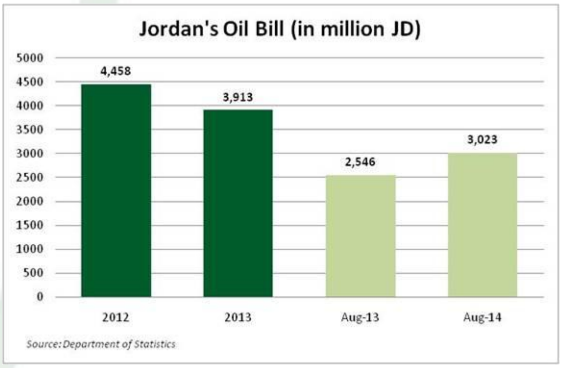
The trade deficit grew 4.1% during the first eight months of the year, reversing a narrowing trend witnessed during the first few months of the year, mainly due to a 19% increase in Jordan's oil imports. Oil imports increased by around JD 477 million over the time period, almost as much as the JD 545 million decline in the oil bill in 2013, indicating low inflow levels of Egyptian gas and increased domestic consumption.

Meanwhile, other imports were largely unchanged, indicating that the extra demand driven by the influx of Syrian refugees has started to fade. On the other hand, national exports picked up as they grew by 7%, while re-exports dropped by 0.1%. The growth in national exports was driven by an increase in fertilizer, vegetable, and clothes exports. As for mining exports, potash exports continued dropping, while phosphate exports have began fluctuating since the beginning of the year. The latest figure shows phosphate exports have grown 9.6%. The drop in re-exports is mainly attributed to the disruption in trade routes, especially to Iraq.

Recently, the government signed a natural gas deal with Noble Energy in an effort to reduce the effect of the oil bill on Jordan's trade balance, but imports are likely to start in 2017. Jordan has also started developing a liquid natural gas (LNG) terminal in Aqaba which is also expected to help alleviate pressure on the oil bill. Meanwhile, recent disruptions in trade routes through Iraq could hurt the bilateral relations with the country and slowdown the

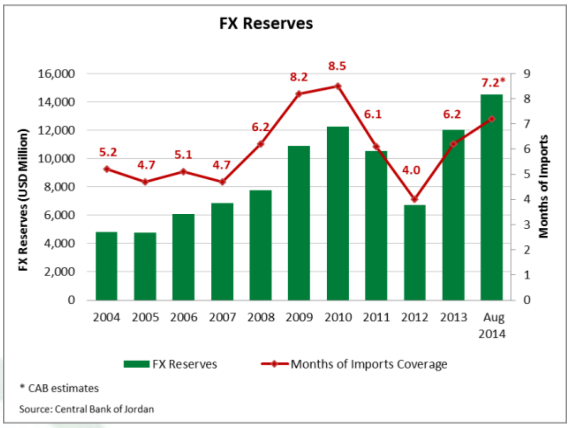






proposed oil pipe between Basra and Aqaba which was likely to reduce the oil import bill and transportation costs. A further deterioration in the political stability in the region could further widen the trade deficit.

Foreign currency reserves continued growing in 2014, registering an all-time high of $14.5 billion at the end of August, enough to cover more than 7 months of imports. The continued rise in FX reserves comes on the back of continued external funding to help support the accommodation of Syrian refugees, continued de-dollarization, and the successful issuance of a $1 billion Eurobond in June of this year. Moreover, tourism receipts showed a 14% increase during the first half of the year.



Overall, Jordan is still susceptible to spillovers from the political instability in the region, and further escalations could lead to an influx of refugees, which could add to pressure to public finance and external balances. Moreover, with no short-term solution to the disruption in Egyptian gas supplies, a swelling oil import bill could strain the current account and increase NEPCO's losses.

Internally, other risks arise from the uncertainty caused by the political instability on FDI and capital inflows, which could dampen private sector confidence. Further ahead, a tightening of monetary policy by the Federal Reserve and a subsequent rise on dollar interest rates could further slowdown capital inflows.

CBJ cuts rates and interest rates trended downwards

Most monetary developments were positive so far this year, due to de-dollarizations trends, better excess liquidity levels, lower market rates on government bonds, and record high FX reserves.

Jordan's central bank cut its benchmark lending rates by 50 basis points in June. The central bank seems to be continuing its expansionary policy, after it previously cut rates by 25bp in January of this year, and 50bp in 2013; focusing on stimulating sluggish growth to shield the economic recovery from the aftermath of the latest rounds of austerity. The moves by the CBJ also helped to control the country's increasing debt services.

During the first eight months of 2014, JD deposits have increased by JD 2.17 million to reach around JD 23.20 billion at licensed banks, following a JD 3.30 billion increase in 2013. On the other hand, foreign currency deposits fell by approximately $0.20 billion for the same period to reach $9.1 billion, after they had dropped by $0.94 million in 2013.

However, the downward trend in foreign currency deposits seems to have reversed recently, as deposits grew for the third consecutive month in August, suggesting that the de-dollarization trend in reaching an end.

The central bank withdrew most of its stimulus liquidity [1] throughout this year, yet excess liquidity levels remained high at around JD 3.4 billion, after increasing by more than JD 1 billion in 2013 – reflecting lower dollarization and lower balance of payment deficit.

Government bond yields plunged significantly since the start of 2013, supported by high coverage ratios, at times above 400%. However, throughout this year, yields seemed to see-saw, yet mostly remained low.

After the latest CBJ cut bonds continued to drop, but seem to have stabilized over the last month, and are in fact ticking up trending upwards.

Benchmark interest rates:

Instrument	2012	2013	Oct 2014
Window rate	4.00%	3.50%	2.75%
O/N Repo	4.75%	4.25%	4.00%
Weekly Repo	4.25%	3.75%	3.00%
Monthly Repo	4.25%	3.75%	3.00%
Re-discount Rate	5.00%	4.50%	4.25%
1-Year Treasury Bills	6.75%	4.28%	3.27%
2-year Treasury Bond	7.95%	4.96%	3.84%
3-year Treasury Bond	8.60%	5.19%	4.37%
Time Deposit Rates	4.19%	4.97%	4.33%*

* As of end-August

Source: Central Bank of Jordan

Growth (%)	2012	2013	As of Aug 2014
JD deposits	-7.30%	18.60%	10.30%
FC deposits	38.00%	-9.20%	-2.10%
JD Private credit	5.70%	4.80%	5.2%*
FC Private credit	8.80%	16.20%	0.00%

Source: Central Bank of Jordan

*CAB estimate

Outlook for interest rates:

Interest rates are likely to remain at current low levels over the next few months, especially as the CBJ may have incentives to cut rates by another 25 basis point rate to stimulate lending and growth, as deposits parked at the overnight window facility remain very high.

Nevertheless there does seem to be some upside risks to the interest rate outlook, particularly when it comes to the country's increasing public debt.

Energy challenges and significant population growth continue to hamper Jordan's economic growth prospects and external position; as the country continues to rely on large and volatile foreign grants and loans inflows to finance its large and persistent current account deficit.

Moreover, according to the government's forecasts from the preliminary 2015 Budget Law, the government expects to finance most of its budget balance deficit in the coming years by domestic borrowing, mainly due to decreasing external borrowing capacity and higher principle payments and redemptions of outstanding external debt. The external debt has increased substantially in the last couple of years, indicating lower external borrowing capacity in coming years.

For 2015, the fiscal deficit, including public entities, is estimated to be around JD 1.5 billion. The whole deficit is expected to be funded from internal sources, while most of the external borrowing will be utilized to redeem external debt principle and interest payments, particularly as a $750 million Eurobond will mature towards the end of 2015.

[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.

Meanwhile, out of the $2 billion IMF loan, $744 million remain for disbursement, of which around $387 million are earmarked to be disbursed in 2015. On the other hand, the government is expected to start repaying the loan in 2015.

However, we expect some downside risks to the interest rate outlook as the government will have an extra source of borrowing from local markets with the emergence of the Sukuk market, the possibility of issuing new USD denominated bonds, and energy projects that are expected to help alleviate Jordan's energy crisis.

The Sukuk funding will enable the government to borrow from Islamic banks that have more than JD 1 billion of excess liquidity, at cheaper rates when compared to conventional bonds borrowing from local commercial banks .

Moreover, the recent drop in oil prices could also place downward risks on the interest rate outlook. In recent official comments, the government expects that a 20% drop in oil prices could lead to a drop in the current account deficit by around JD 800 million. This in turn will lead to increased excess liquidity in the market and decreased pressures on FX reserves, which will place downward pressures on interest rates.

Nevertheless, we believe that risks will be tilted to the upside and expect interest rates to increase particularly towards the end of 2015.

Interest Rate Outlook Risk Matrix:

Upside Risks	Downside Risks
✓ Major dependence on domestic borrowing in 2015; expected at around JD 1.5 billion. ✓ Lower net increase in foreign borrowing; adversely affecting local liquidity levels, and foreign reserves levels. ✓ Lower growth and inflation rates, sluggish growth in credit facilities, and decreasing de-dollarization trend, resulting in lower growth rates for JOD deposits in the market. ✓ External shocks including increased influx of refugees. ✓ Volatility in foreign grants. ✓ Expectations of Fed rate hikes next year.	✓ The emergence of the Sukuk Market which can provide the government with cheap funding with an approximate amount of JD 500 Million. ✓ The possibility of issuing new USD government bonds in the local market. ✓ Energy projects to reduce the pressure on the balance of payments. ✓ Significant support to the country in terms of foreign grants; driven by geopolitical developments. ✓ CBJ Interest rate cuts. ✓ Continued lower prices of oil.

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