Brussels, 29.4.2013
COM(2013) 242 final

2013/0128 (COD)

Proposal for a

DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

providing macro-financial assistance to the Hashemite Kingdom of Jordan

{SWD(2013) 151 final}

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

Grounds for and objectives of the proposal

Since early 2011, Jordan's economy has been significantly affected by the domestic events related to the Arab Spring and the ongoing regional unrest, notably in neighbouring Egypt and Syria. Combined with a weaker global environment, the political transition of Jordan has taken a heavy toll on external receipts and has strained public finances. Lower tourism and FDI inflows, higher international energy prices and the repeated disruptions to the flow of natural gas from Egypt, which forced Jordan to replace gas imports from Egypt with more expensive fuels for electricity generation, have put a drag on growth and have resulted in a marked deterioration in the balance of payments and fiscal position. Jordan has also been affected by the intensification of the Syria crisis, notably through the inflow of refugees and its fiscal implications. While Jordan has so far managed to date to maintain macroeconomic stability, including through substantial fiscal consolidation efforts and financial support from foreign donors, there are significant balance of payments and financing needs.

Under the pressure of a sharp drop of international reserves in the first half of 2012, the Jordanian authorities have agreed on a USD 2 bn (800% of quota), 36-month Stand-By Arrangement (SBA) with the IMF, approved in August 2012.

In view of the worsening economic situation and outlook, the Jordanian government requested Macro-Financial Assistance (MFA) from the EU in the amount of EUR 200 mn in December 2012. The Commission intends to submit to the European Parliament and the Council a proposal for MFA to the benefit of the Hashemite Kingdom of Jordan amounting to a maximum of EUR 180 mn in the form of a medium term loan. The proposed legal base is Article 212 of the TFEU.

The EU's MFA would contribute towards covering Jordan's residual external financing needs in 2013 and 2014, in the context of the IMF programme. The MFA would help Jordan address the lingering economic consequences of the Arab Spring and the external shocks of its energy sector. It would reduce the economy's short-term balance of payments and fiscal vulnerabilities, while supporting the adjustment and reform programmes agreed with the IMF and the World Bank, as well as the reforms agreed under the EU's budgetary support operations (including the Good Governance and Development Contract operation of EUR 40 mn financed by the *Support for Partnership Reform and Inclusive Growth* (SPRING) programme).

The proposed assistance would promote policy measures to improve public financial management and tax reform while strengthening the social safety net (including through a better targeting of the cash transfers system put in place last November to compensate households for the reform of the energy subsidy system); measures to improve the regulatory framework and climate for investment; and reforms to reduce unemployment and encourage participation in the labour market, notably among women.

The proposed MFA is consistent with the political and financial pledges made by the EU to the Jordanian authorities at the EU-Jordan Task Force meeting in February 2012. It is also in line with the aims of the new partnership for the South Mediterranean region proposed at the G8 Deauville summit and the orientations of the new European Neighbourhood Policy. In the

same vein, it would signal to the other countries in the region that the EU is ready to support countries like Jordan, embarking on political reforms, in moments of economic difficulties.

In this context, the Commission considers that the political and economic pre-conditions for a MFA operation of the proposed amount and nature are satisfied.

General context

Jordan has faced worsening economic conditions since 2011 due to the regional and political turmoil associated with the Arab Spring and the weaker regional and global economic environment. These circumstances negatively affected two of the main external drivers of economic growth, namely tourism receipts and foreign direct investment (FDI). In addition, the frequent interruption of gas supplies from Egypt has forced the government to replace gas with more expensive oil imports, which has increased the import bill significantly[1]. These adverse external shocks have contributed to create large fiscal and external imbalances.

In this context, and following a period of robust economic growth averaging 6.5% during 2000-2009, partly reflecting a propitious external environment, GDP growth dropped sharply to 2.6% in 2011. GDP growth picked up moderately to 2.9% in the first half of 2012, following a recovery of tourism receipts and despite the weak performance of the mining and construction sectors. In 2013, GDP growth is projected to be supported by increased FDIs in the energy and banking sectors but remain relatively low (at about 3%).

Consumer price inflation increased moderately in the course of 2012, reaching an average of 4.8%, compared to 4.5% in 2011, as the impact of domestic fuel and electricity tariff increases was partially offset by that of weaker domestic demand. Inflation is expected to rise further to 6.1% on average in 2013, partly as a result of the foreseen energy price adjustments. Since mid-2011, monetary policy has been tightened in order to preserve the attractiveness of JOD-denominated assets. The current fixed exchange rate policy (peg to the USD) has helped anchor inflation expectations.

The external position has worsened markedly since the beginning of 2011 due to the aforementioned shocks. The current account deficit (including grants) reached 12% of GDP in 2011 (19% of GDP excluding grants), up from 7.1% of GDP in 2010 (11.3% of GDP excluding grants), partly due to a 16.6% increase in the import bill. By the end of 2012, it had widened further to 17% of GDP (20.6% of GDP excluding grants), despite a 15.3% increase in tourism receipts (broadly attributed to tourist flows from Arab countries) and a 3.5% increase of remittances. The projection is, however, that the current account deficit excluding grants will narrow down to 12.1% in 2013 in view of stronger export growth and a gradual normalisation of gas supplies from Egypt. The shortfall in FDI in 2011-2012 further deteriorated the external position. Financing needs for 2011-12 were largely met through foreign assistance, in particular form the Gulf Cooperation Council (GCC) countries and the Bretton Woods institutions, and the mobilisation of international reserves, which fell by 14% (to USD 10.7 billion) in 2011 and more dramatically throughout 2012, to reach USD 5.2 billion (just above 3 months of imports) by the end of the year.

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1 Although in mid-January Jordan's Egyptian gas supplies temporarily returned to normal levels after nearly two years of reduced supply (240 million cubic feet per day compared to an average of 40 mcf for most of 2012), they have recently dropped again to one-third of their normal levels, prompting fresh concerns over the security of the country’s primary energy source. Moreover, the renegotiation of the gas supply contract with Egypt has approximately tripled its price.

Public finances have been under strain due to the social expenditure packages adopted in 2011, the budgetary impact of the increase in energy import prices and the economic slowdown. The budget deficit excluding grants increased from 7.7% of GDP in 2010 to 11.7% in 2011, while public debt had risen to 70.7% of GDP by end-2011 (from 67.1% of GDP at end-2010). Although the 2012 budget adopted in February envisaged a large fiscal adjustment compared to 2011, by mid-year it had become clear that this could no longer be possible, reflecting much higher than assumed fuel subsidies, a higher wage bill due to the reform of the civil service, higher pension and health outlays, and spending on housing and medical assistance for Syrian refugees[2]. To mitigate debt sustainability and possible shortfalls in external flows, the government decided in May 2012 to take additional fiscal measures, amounting to 3.4% of GDP. The aim was to lower the overall deficit in 2012 by approximately 1.5 percentage points of GDP (to 10.7% of GDP, excluding grants).

On the expenditure side, fiscal consolidation measures (amounting to 2.9% of GDP) included: the removal of subsidies on gasoline octane 95, jet fuel and heavy fuel oil; a 13% decrease in the subsidy for gasoline octane 90; a 6% increase in the price of diesel; as well cuts in capital spending and current expenditure. On the revenue side, the consolidation effort amounted to 0.4% of GDP and included, inter alia, the introduction of a sales tax on cellular phones and air conditions; the increase in the taxes on cars, air tickets and alcoholic and tobacco products; and the removal of certain tax exemptions.

In early September 2012, the government took the decision to introduce a 6% tax on diesel and to remove subsidies from gasoline octane 90. However, this decision, which is a structural benchmark of the IMF programme, was initially suspended by the King. The liberalization of gasoline octane 90 finally took place in mid-November (together with the lifting of subsidies on diesel, kerosene, and household gas prices), in full alignment with the price adjustment structural benchmark set by the IMF program. Although these measures led to serious social protests in mid-November, the government maintained the fuel price adjustments.

As underlined at the Joint Dialogue on Economic Reforms conducted by the Commission with the Jordanian authorities last October, Jordan has made significant progress in a number of key reform areas. This includes the adjustment of energy prices, plans to diversify the energy supply, measures to raise women's participation in the labour force, schemes to support SMEs access to finance, and the submission to parliament of legislative proposals on income taxation, PPPs and social security reform. However, substantial structural reform challenges have yet to be addressed. Moreover, many legislative proposals remain stuck in parliament and the dissolution of the parliament and organisation of parliamentary elections held at end-January 2013 further delayed their adoption.

On 3 August 2012, the IMF Board approved, as noted, a USD 2 bn (800% of quota) 36-month Stand-By Arrangement (SBA) for Jordan. The programme is relatively frontloaded, with 300% of quota (out of the total of 800%) paid out in the first two tranches (the second tranche is to be disbursed upon completion of the first programme review). The program envisages a package of measures aimed at strengthening growth while reducing vulnerability to exogenous shocks, notably by reforming the energy subsidies system, bringing NEPCO back

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[2] Jordan is being seriously affected by the on-going Syrian refugee crisis. With the biggest influx of Syrian refugees (about 180,000 by January 2013) and the fastest growing refugee camp (about 1,000 Syrians crossing Jordanian borders every day), Jordan has been the most affected country in the region at a time the economy is already grappling with severe shortages of water and electricity. Since the outbreak of the Syrian conflict, the budgetary cost of hosting Syrian refugees is estimated to have exceeded EUR 600 mn (about 3% of the Kingdom's GDP).

to cost recovery and promoting energy supply diversification. The program further foresees consolidating the fiscal sector through an effective rationalization of the tax system, improved tax administration and cuts in expenditure. For 2013, substantial additional fiscal adjustment measures are planned, including increases in diesel and kerosene prices, reductions in tax exemptions and, possibly, increases in excise taxes, with the aim of cutting the fiscal deficit excluding grants to 9.3% of GDP for that year (5.5% including grants).

Based on the latest available IMF projections, the external financing gap for the IMF programme period (2013-2015) is estimated at USD 5.9 billion, essentially reflecting a sizeable (although declining overtime) current account deficit and the need to rebuild official foreign exchange reserves With reserves already at a critically low level at the end of 2012 (just above the minimum benchmark of 3 months of imports, as noted), and Jordan's balance of payments remaining very vulnerable to external shocks, notably further disruptions in gas supplies from Egypt and political developments in the region, the IMF programme aims at a considerable replenishment of official reserves. Net of disbursements under the SBA and the World Bank's Development Policy Loan (DPL), Jordan faces a residual external financing gap of USD 4.1 billion over these three years to be covered by other donors (GCC countries, US, EU, France, and Japan). The proposed MFA from the EU would correspond to about 4.4% of the residual external financing gap.

Existing provisions in the area of the proposal

None

Consistency with the other policies and objectives of the Union

The EU has for long had an interest to engage with Jordan, acknowledging Jordan's stabilizing role in the region as well as its mutual economic and financial links. The contractual relations between the EU and Jordan are framed by the Association Agreement in May 2002, which liberalizes trade between the two parties and foresees the strengthening of our bilateral political dialogue and economic cooperation. Bilateral relations have been further reinforced under the EU's European Neighbourhood Policy (ENP), including through the adoption of a five-year ENP Action Plan in 2005, replaced by a new 5-year Action Plan in 2010, which identifies key reform measures in both the political and economic spheres and promotes Jordan's regulatory convergence with the EU. Moreover, Jordan is the first Mediterranean partner country with whom the EU has concluded technical negotiations leading to an "Advanced Status". It is also a member of the Union for the Mediterranean. Economic ties with the EU are also important. In 2011, the EU was Jordan's first source of imports (20.1%), although it was only the seventh destination of Jordan's exports. And the EU has offered to Jordan, as noted, the negotiation of DCFTA with the goal to increase Jordan's integration into the EU single market.

In sum, while Jordan's road to full democracy is not without difficulties and significant uncertainties remain, the country has taken significant steps towards political and economic reform and there is also a strong framework of bilateral relations between the EU and Jordan.

Since the Arab Spring began, the EU has declared on various occasions its commitment to support Jordan in its economic and political reform process. Indeed, the EU’s commitment to support Jordan’s political and economic reform was the main message of the first EU-Jordan Task Force held in Amman in February 2012.

The MFA proposal is consistent with the EU's commitment to support Jordan's economic and political transition. It is also consistent with the guidelines for the MFA, as provided by the

Council conclusions of 2002 on MFA and the accompanying letter of the Council President to the Commission President. In particular, and as explained in more detail in the Staff Working Document accompanying the Commission's proposal, the proposal is consistent with the following principles: exceptional character, political preconditions, complementarity, conditionality and financial discipline.

The Commission will continue to monitor and assess during the life of the MFA operation satisfaction of these criteria, including the assessment, in close liaison with the European External Action Service, of the political preconditions.

2. RESULTS OF CONSULTATIONS WITH THE INTERESTED PARTIES AND IMPACT ASSESSMENTS

Consultation of interested parties

MFA is provided as an integral part of the international support to the economic stabilisation and recovery programme of Jordan. In the preparation of this proposal for MFA, the Commission services have consulted with the International Monetary Fund and the World Bank, which have already put in place sizeable financing programs. The Commission consulted the EU Member States in the Economic and Financial Committee before submitting its proposal for MFA. The Commission has also been in regular contact with the Jordanian authorities.

Collection and use of expertise

An Operational Assessment verifying the quality and reliability of Jordan's public financial circuits and administrative procedures will be carried out by the Commission with the assistance of external experts.

Impact assessment

The MFA and the economic adjustment and reform programme attached to it will help alleviate Jordan's short-term financing needs while supporting policy measures aimed at strengthening medium-term balance of payments and fiscal sustainability and raising sustainable growth, as agreed with the IMF. It will notably help improve the efficiency and transparency of public finance management; promote fiscal reforms to increase tax collections and improve the progressivity of the tax system; support existing efforts to strengthen the social safety net; promote labour market reforms (to reduce unemployment and raise participation rates, notably among women); and facilitate the adoption of measures to improve the regulatory framework for trade and investment.

3. LEGAL ELEMENTS OF THE PROPOSAL

Summary of the proposed action

The European Union shall make MFA available to Jordan for a total maximum amount of EUR 180 million, provided in the form of a medium term loan. The assistance will contribute to cover Jordan's residual external financing needs in 2013-14, as identified by the Commission based on the estimates of the IMF.

The assistance is planned to be disbursed in two loan instalments and to allow some frontloading given the urgency of the financing needs. The disbursement of the first

instalment is expected to take place in the second half of 2013. The second instalment, conditional on a number of policy measures, could be disbursed in the first half of 2014. The assistance will be managed by the Commission. Specific provisions on the prevention of fraud and other irregularities, consistent with the Financial Regulation, are applicable.

As usual with the MFA instrument, the disbursements would be conditional on successful programme reviews under the IMF's financial arrangement (the SBA). In addition, the Commission and the Jordanian authorities would agree on specific structural reform measures in a Memorandum of Understanding. The Commission will target structural reforms aimed at improving the overall macroeconomic management and the conditions for sustainable growth (e.g. targeting the transparency and efficiency of public finance management; fiscal reforms; reforms to strengthen the social safety net; labour market reforms; and reforms to improve the regulatory framework for trade and investment).

The decision to disburse the full MFA in the form of loans is justified by Jordan's level of development (as measured by its per-capita income) and debt indicators. It is also consistent with the treatment given to Jordan by the World Bank and the IMF. Indeed, Jordan is not eligible for concessional financing from either the IDA or the IMF's Poverty Reduction and Growth Trust fund.

Legal basis

The legal basis for this proposal is Article 212 of the TFEU.

Subsidiarity principle

The proposal falls under the mixed competence of the EU. The subsidiarity principle applies to the extent that the objectives of restoring short-term macroeconomic stability in Jordan cannot be sufficiently achieved by the Member States alone and can therefore be better achieved by the European Union. The main reasons are the budgetary constraints faced at the national level and the need for strong donor coordination in order to maximise the scale and effectivenes of the assistance.

Proportionality principle

The proposal complies with the proportionality principle: it confines itself to the minimum required in order to achieve the objectives of short-term macro economic stability and does not go beyond what is necessary for that purpose.

As identified by the Commission based on the estimates of the IMF in the context of the SBA Arrangement, the amount of the assistance corresponds to 4.4% of the residual financing gap for the period 2013-2015. This is consistent with standard rules on burden-sharing for MFA operations. Given the assistance pledged to Jordan by other bilateral and multilateral donors and creditors, it is deemed an appropriate level of burden-sharing for the EU.

Choice of instruments

Other instruments would not be adequate because, in the absence of a framework regulation for Macro-Financial Assistance, ad hoc European Parliament and Council decisions under Article 212 TFEU are the only available legal instrument for this assistance.

Project finance or technical assistance would not be suitable or sufficient to address these macroeconomic objectives. The key value added of the MFA in comparison to other EU instruments would be to alleviate the external financial constraint and to help create a stable macroeconomic framework, including by promoting a sustainable balance of payments and budgetary situation, and an appropriate framework for structural reforms. By helping to put in place an appropriate overall framework for macroeconomic and structural policies, MFA can increase the effectiveness of the actions financed in Jordan under other, more narrowly focused EU financial instruments.

4. BUDGETARY IMPLICATION

The planned assistance would be provided in the form of a loan and should be financed through a borrowing operation that the Commission will conduct on behalf of the EU. The budgetary costs of the assistance will correspond to the provisioning, at a rate of 9%, of the amounts disbursed in the guarantee fund for external lending of the EU, from budget line 01 04 01 14 ("the provisioning of the Guarantee Fund"). Assuming that the first loan disbursement will be made in 2013 for the amount of EUR 100 million and the second loan disbursement in 2014 for the amount of EUR 80 million, and according to the rules governing the guarantee fund mechanism, the provisioning will take place in the 2015-16 budgets.

5. OPTIONAL ELEMENTS

Review/revision/sunset clause

The proposal includes a sunset clause. The proposed MFA would be made available for two years, starting from the first day after the entry into force of the Memorandum of Understanding.