BANK OF JAMAICA

Quarterly Press Briefing

MODERNISING JAMAICA'S FOREIGN EXCHANGE MARKET: THE PIVOT TO INFLATION-TARGETING

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Good morning, ladies and gentlemen.

Today, Bank of Jamaica is pleased to release the Quarterly Monetary Policy Report for the July to September 2017 quarter.

A Modern Foreign Exchange Market

Due in no small part to the successful implementation of the strenuous economic reforms of recent years, **I am pleased to report that Jamaica's transition to a modern competitive foreign exchange market is now successfully in train. Like inflation and the fiscal accounts before this, a new phase or era has begun for the foreign exchange market.** Two elements are important in understanding this new phase: first, the fundamental changes that have occurred in market behaviour and, second, the change that we have made in how Bank of Jamaica interacts with the market.

The foreign exchange market has at last moved away from being a market where the exchange rate more or less constantly drifts in one direction only to a more normal two-way market where the exchange rate is just as likely to move up as it is to move down, in other words, a more modern market with a flexible exchange rate that both produces and benefits from a fairly valued currency.

Up to 23 November, the exchange rate appreciated on 127 different days since the start of 2017, while depreciating on 98 days. This compares to 174 days of depreciation over the same period in 2016, during which there were 51 days of appreciation.

Since the start of 2017, the Jamaican dollar has experienced at least three cycles, or episodes, of upswings followed by downswings. A smaller cycle in January was followed by a more pronounced one from May to July.

The current episode saw even sharper depreciation in the August to September period followed by a strengthening move in October that marked the start of a sustained improvement in the value of the Jamaican dollar. This may have been prompted by the response of market participants to increased US dollar supply arising from an unexpected early redemption of a Government of Jamaica US dollar bond, the issuance of a local currency bond indexed to US dollars by a local banking entity and, somewhat later in the cycle, a significant reduction in the amount of foreign exchange that authorised dealers and cambios are obliged to sell to Bank of Jamaica each day (known as the foreign currency surrender requirement).

It is also true, no doubt, that a number of market participants may have overbought during earlier cycles and in the earlier phase of the current cycle thereby exacerbating the conditions of excess supply and reduced demand that have been driving the current strengthening trend. The picture is made complete when we add to this the generally buoyant inflows into the market due in part to a surge in tourism arrivals and spending.

In all of this, for the 12 months to 23 November 2017, the Jamaican dollar appreciated by 1.9 per cent, compared with depreciation of 7.7 per cent over the same period of the previous year.

Importantly, these changes in market behaviour are occurring in the context of a currency that remains broadly fairly valued. A key indicator of this valuation is the performance of the external accounts. We have said this before on many occasions but it still needs to be repeated so that we all grasp this fact: **the current account of the balance of payments less imports already paid for by foreign direct investment has been in surplus for the past two fiscal years.** In other words, the income earned from abroad by Jamaica from exports of goods and services exceeds the amount that we spend to pay for the imports that are not already paid for by foreign direct investment. The Bank's forecast is for this trend to continue into the medium term. **In light of this, the performance of the exchange rate should not be a surprise.**

With the introduction of Bank of Jamaica's Foreign Exchange Intervention and Trading Tool (B-FXITT) in July, Bank of Jamaica has reformed the way it interacts with the market. The initial intent of B-FXITT, in addition to enhancing market efficiency and transparency, is to provide market participants with reassurance about the availability of future supplies of foreign exchange. Thanks to favourable market conditions, including increased inter-dealer trading, Bank of Jamaica has already been able to reduce its sales to the market in the face of declining net demand and is now preparing to announce the introduction of buying operations under B-FXITT. **Bank of Jamaica is reducing its footprint in the foreign exchange market and intends to continue that trend, subject to market conditions.**

It is important to note that in this new reality of two-way exchange rate movements, the market will become more liquid, transparent and conducive to innovation. Buyers and sellers will now be required to plan more carefully as there is no longer a safe one-way bet on the direction the exchange rate will take. This uncertainty is expected to encourage further market development, as financial institutions develop hedging tools to satisfy the needs of buyers and sellers of foreign exchange. The two-way volatility and increased hedging activity will further reduce the exchange rate pass-through to inflation, allowing Jamaica to move with greater confidence towards the desired goal of full-fledged inflation targeting.

Adequate supplies of foreign exchange and a significantly reduced exchange rate impact on inflation will eventually weaken the misplaced focus of the public on the exchange rate as a key measure of overall economic performance and the primary indicator of future inflation. The central bank's focus on low inflation can then take centre stage and, as a private sector leader has already pointed out, the key indicator for us all to watch will be inflation.

Inflation Targeting

With this in mind, **we can together take note of the significant milestone passed in September 2017 with the approval by the Minister of Finance and the Public Service for the first time of a medium-term inflation target for Bank of Jamaica. The target has been set by the Minister at 4.0 per cent to 6.0 per cent.**

This new continuous medium-term target allows the public to hold the Bank to account for the outcomes of the more forward-looking monetary policy strategy used by Bank of Jamaica in light of the known lags in the monetary transmission mechanism. The medium-term inflation target is also more clearly harmonised with the projected outcomes of fiscal policy set out in the Government's Fiscal Policy Paper.

The inflation target was selected on the basis of the country's current and prospective economic circumstances. Bank of Jamaica has already been operating with relatively low levels of inflation. The 12-month inflation rate at October was 4.7 per cent and we are projecting that inflation will remain broadly at this level for the next four to eight quarters. Core inflation remained stable below 4.0 per cent and inflation expectations remain broadly anchored around the Bank's target.

Under the inflation-targeting regime, Bank of Jamaica makes adjustments to monetary policy on the basis of its medium-term inflation forecast. The forecast is updated quarterly and is routinely shared with the public. When the assessment signals that there is a risk to the Bank achieving the inflation target then the Bank will react by adjusting the policy interest rate. The policy rate will therefore be increased if the assessment suggests that inflation will tend to exceed the upper bound of the target, ie, over 6.0 per cent. The policy rate will, conversely, be reduced if inflation is projected to fall below the lower bound of the target, ie, below 4.0 per cent.

Recent Monetary Policy Actions

Last week, Bank of Jamaica reduced the policy rate to 3.25 per cent from 3.50 per cent. This follows the 0.25 percentage points reduction to 3.50 per cent in August. These policy actions are consistent with positive economic indicators and the view that inflation will remain comfortably within the target of 4.0 per cent to 6.0 per cent over the next four to eight quarters. Government's continued strong commitment to fiscal consolidation is also a factor.

I will remind you that in July 2017 Bank of Jamaica adopted as the policy rate the interest rate it pays on overnight deposits, replacing the interest rate on 30-day certificates of deposit. This was a move that was intended to strengthen the transmission of changes in monetary policy; meaning, how quickly and fully a change in the policy rate leads to changes in market interest rates and lending rates.

Other Economic Developments

Turning to the broader economy, we are encouraged by the employment results in STATIN's October release which tell an important positive story but also present some issues for further policy debate. The economy added 29,200 net new jobs over the year to July 2017. The unemployment rate declined to 11.3 per cent, down 1.6 percentage points from a year earlier. **This represents the lowest unemployment rate since July 2009 and suggests that employment is growing faster than the labour force. While these numbers are heartening, they also suggest that Jamaica is beginning to approach its capacity limits in terms of skilled labour. It is therefore becoming critical for the country to increase the pool of skilled workers in order to facilitate sustained economic growth without igniting faster inflation.** This is an issue that we will speak about more fully in the future.

Looking Forward

Ladies and gentlemen, these and other developments point to an improving economy where macroeconomic stability as a foundation for growth appears to be entrenched. This is underpinned by the remarkably strong performance recorded to date under the IMF-supported economic programme.

The stable outlook for inflation and continued fiscal consolidation encourages continuation of the Bank's accommodative policy stance in support of further improvements in domestic output and employment.

Thank you.