

FOREIGN EXCHANGE MARKET DYNAMICS: WHAT ARE THE FACTORS THAT INFLUENCE THE EXCHANGE RATE? Part 3

by Tony Morrison

LOOKING FORWARD: WHERE DO WE WANT TO GO FROM HERE?

COMPOSITION OF THE ECONOMY

The bulk of the Jamaican economy is not engaged in earning foreign exchange, and this imbalance perhaps places some strain on our ability to consistently earn enough to “pay our way” as a country.

To become a strong economy driven and sustained by hard currency earnings, then either existing exporters need to export more, more businesses need to get involved in earning foreign currency, or perhaps both. On top of that, a significant portion of those entities not directly engaged in earning foreign currency (in addition to many who already are) should also be involved in saving foreign currency by concentrating on import-substitution.

So-called “linkages” are also very important. We speak of it often in tourism, referring to local suppliers who produce goods and services to support that sector, but it is also very important to focus on those who can produce raw material and other goods and services needed by our local exporters.

Our export sector is somewhat complicated by the fact that the inputs of some exporters are heavily dependent on imports. However, we are happy to note that in tandem with changing conditions and the ongoing economic reforms in recent years, several in this position have already creatively re-examined their business models. Some have found creative ways to produce more of their own inputs, thus lowering costs and increasing employment, so they are now reaping the benefits of the new environment with significantly increased exports. With more research and applied technology, hopefully more will follow this trend and more linkages will also emerge to assist them.

The high cost of energy also has implications for the cost of local production as well as being a drain on our foreign exchange market. While Jamaica has benefitted from a sustained period of lower oil prices, the country still remains vulnerable to any future oil price shocks and imported oil represents a disproportionate segment of our balance of payments. **Ongoing public and private sector initiatives to mitigate our oil dependence and lower the local cost of delivering energy are therefore to be**

applauded, and continuing on the path to increased energy efficiency – and self-sufficiency – is critical to fuelling further economic growth.

What we must keep in mind, overall, is that a future of sustainable economic growth is dependent on being an export-led economy. Our ongoing structural reforms and current policies are therefore designed to facilitate and achieve this, because this is what we want.

CURRENCY STRENGTH IS NOT NECESSARILY AN INDICATOR OF ECONOMIC HEALTH

Many Jamaicans tend to see the value of the Jamaican dollar as a critical indicator of overall economic health, and this is not necessarily the case. The exchange rate is merely the price of a commodity. There are examples of very strong economies with relatively weak currencies, such as China and Japan.

Japan is the 3rd largest economy in the world in terms of GDP and a giant compared to Jamaica, yet it has an exchange rate of around 110 to 1 against the US dollar, not much stronger than the Jamaican dollar.

Historically, a long term exchange rate trend of a negative drift in one direction only was not a healthy sign, as it was a reflection of a large and persistent current account deficit. Moving to correct that problem, however, does not automatically mean that the ideal scenario is an exchange rate that either constantly appreciates or remains static at any particular level.

We will always be a relatively small economy, so no matter how well we do, it is a bit of a stretch to expect that our dollar can realistically become as strong as or stronger than the currency of larger and more advanced countries. Even if that were the case, then it may still suit us at times to have a weaker currency, like China and Japan, to give us an advantage in trade.

We must remember that when the exchange rate remains in a zone that is consistent with our overall economic performance relative to our trading partners, and particularly when our national earnings in foreign currency approximate our national spending, then the exchange rate is fairly valued. It will, however, fluctuate around this level over time as specific demand and supply conditions can change from day to day and from month to month. This will include changes in perception as well as real changes that are happening on the ground locally or internationally.

So yes, on a day-to-day basis, a normal and healthy foreign exchange market is one where we should see periodic movements of the exchange rate in both directions responding to current market conditions. These movements should mostly cancel each other out over annual business and seasonal cycles and it shouldn't matter seriously if the rate ends up a bit above or below where it was the year before. That is the kind of market we want.

A DEEP AND EFFICIENT FOREIGN EXCHANGE MARKET

What we are trying to achieve is a foreign exchange market adequately funded by the robust exports of high-quality Brand Jamaica goods and services, heavily influenced by the savings of competitive import substitution, plus robust remittances and high-quality foreign direct investments.

We want a foreign exchange market deep enough that even after some local investors retain foreign exchange for savings and investments, even after foreign investors repatriate profits to external shareholders, and even after the central bank accumulates reserves to fulfil its obligations, there is still more than enough left to satisfy overall demand.

Jamaica's thrust to develop a deeper market, however, means much more than adequate supply conditions.

A true twenty-first-century market is one that meets the two objectives a market must satisfy if it is to be truly considered efficient and modern. Firstly, a buyer or seller must be able to do the transaction that they want when they want to and in the amount that they want; in other words, it must be liquid. Secondly, having done a transaction, they should leave the market with confidence that it was done at a fair price.

A modern market also involves a central bank that manages and interacts with the market in a predictable, transparent and efficient way, with mechanisms that accurately reflect and report day-to-day and trend market conditions. Hence the introduction of the BOJ Foreign Exchange Intervention & Trading Tool (B-FXITT).

Another characteristic of a modern market is a high level of inter-dealer trading, instead of dependence on the market presence of the central bank. In addition, all participants in a modern market should expect to be treated fairly, hence the pending introduction of a code of conduct for all market participants.

It is important to note that in the current reality of two-way exchange rate movements, the market will become more liquid, transparent and favourable to innovation. Buyers and sellers now have 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. Buyers and sellers of foreign exchange will desire protection from short-term fluctuations as they transact medium and long term business, so financial institutions will develop hedging tools to satisfy this demand.

This 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 goals of full-fledged inflation targeting and eventually matching the inflation rate of our trading partners.

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