

B-FXITT PRESCRIPTION:
IMPROVING THE WAY BOJ SELLS FOREIGN EXCHANGE
by Tony Morrison, September 2017.

A successful pilot in June and a seamless launch in July. Bank of Jamaica's new and improved foreign exchange trading tool is up and running.

Well, one part of it, to be fair, as the BOJ Foreign Exchange Intervention & Trading Tool (B-FXITT) is intended to facilitate buying as well as selling foreign exchange. However, to avoid any risk of confusing the market, the central bank opted to introduce the selling side of the operation first.

But how did BOJ sell foreign exchange before, and what were the weaknesses in that method which B-FXITT is supposed to fix?

How BOJ sold Foreign Exchange before B-FXITT:

BOJ would inform all authorized dealers (ADs) and cambios, usually on the same day, that it intends to sell an undisclosed sum of foreign exchange at a fixed price. Bids would be invited and sales were typically settled on the same day, using the previous day's weighted average selling rate (WASR).

Weaknesses of the Old Selling Mechanism:

The old method was admittedly simpler, but had intrinsic weaknesses.

In a dynamic market, using the previous day's WASR would not always reflect the true market price on the day of the transaction. This meant that some institutions may have bought foreign exchange from the central bank at a price either too expensive or too cheap, compared to what they might have paid in the open market.

Using the previous day's WASR or some arbitrary rate for intervention therefore potentially allowed some institutions to exploit BOJ operations and buy foreign exchange from the central bank relatively cheaply. BOJ interventions could at times therefore inadvertently induce demand beyond whatever systemic imbalance the intervention attempted to address, so the problem got worse before it got better.

B-FXITT addresses this problem immediately, as next-day settlement is based on actual bid prices. For full transparency, BOJ also publishes a full report on the same day, which includes the WASR arising from the B-FXITT operation.

This B-FXITT report, on the day of transactions, is in addition to the existing comprehensive end-of-day report encompassing overall market activity which BOJ now publishes each working day. In addition, as a further boost to the transparency and efficiency of the market, BOJ intends to eventually introduce a daily mid-day trading rate.

When BOJ sold foreign exchange at a fixed price, it was not a truly market-determined rate, participants had no flexibility, and BOJ unilaterally allocated the funds, all of which did not necessarily align with market conditions or the economic priorities at play in the system. B-FXITT mitigates these issues and levels the playing field for all participants by being a competitive multiple-price tool. **Through B-FXITT, BOJ now sells at market-determined rates, and so the average daily rate at those times are now a much more accurate reference rate.** Eligible AD's and cambios are now free to bid at prices reflecting current market conditions, and within the limits of the terms of B-FXITT and what quantities are offered, can bid for quantities which suit their particular needs and customers' needs at the time. B-FXITT also involves a transparent and systematic method of allocating the funds, which is fully reflected in the published report on each operation.

Pre-B-FXITT foreign exchange sales were not widely announced, and so outside of reporting from a few astute journalists, the public was generally unaware of BOJ's

intervention operations. Moreover, because market discussions were usually more immediate than long term, BOJ itself was sometimes not fully aware of a build-up of excess demand in the system until participants could no longer postpone their needs. When this occurred, it could result in panic buying and multiple bids, which multiplied the signal, resulting in lurches in the exchange rate. A single entity trying to buy US\$10 million asking three different banks for the funds, for instance, could be misread by the system as a demand for US\$30 million.

B-FXITT addresses this weakness by providing much more information and assurance than ever before, and automatically makes the market more open and efficient in addition to enhancing stability. In addition to comprehensive reports on the day of each B-FXITT operation, the calendar of operations and the amount of US\$ funds being sold each week is now provided four weeks in advance. This advance calendar puts all market participants in a better position to plan, and the assurance of liquidity gives sellers less incentive to hoard. B-FXITT also forces the central bank and all authorized market participants to upgrade their market intelligence and talk to each other more. The amount of money BOJ offers for sale each week will be based on the information it has available on what the market does or does not need at specific times. Where they are able to do so, it serves the interest of all market participants to assist the central bank in this regard. The better the market can identify its own needs and inform BOJ accordingly enables the central bank to better plan its allocation schedule to better address the needs of the market and anticipate any impending imbalances to address.

However well it works, though, B-FXITT is merely a means to improve the efficiency of the foreign exchange market and cannot change the overall fundamentals which influence that market.

It is not intended to significantly influence the exchange rate, but instead to more accurately reflect true market rates.

The ideal situation we desire eventually is a foreign exchange market so adequately supplied by earnings that BOJ will have to cut back on weekly sales and concentrate mostly on buying.

Achieving this requires the formula we already know; continued improvements in economic performance built on our ongoing reform programme:

1. Continued fiscal discipline.
2. Low inflation.
3. Improved balance of payments driven by increased exports of goods and services.
4. Greater reliance on cheaper and renewable energy sources.
5. Competitive import substitution.

Editorial note: A slightly edited version of this article has been published in the Jamaica Gleaner: <http://jamaica-gleaner.com/article/business/20170908/tony-morrison-b-fxitt-prescription>