

B-FXITT PRESCRIPTION, PART 2:

MODERNIZING THE WAY BOJ BUYS FOREIGN EXCHANGE

by Tony Morrison, September 2017.

The recently-introduced BOJ Foreign Exchange Intervention & Trading Tool (B-FXITT) covers both how the central bank buys as well as sells foreign exchange. Bank of Jamaica, however, opted to concentrate first on getting the selling side right. So far, it has been operating smoothly, and BOJ is now preparing to introduce the buying side of B-FXITT.

How BOJ Currently Buys Foreign Exchange:

The public may be generally unaware of this, but the central bank is in the foreign exchange market as a buyer on a daily basis.

BOJ buys foreign exchange for three main reasons:

1. As banker to government, the central bank is responsible for selling foreign exchange to central government to facilitate timely payment of external obligations, including debt payments. A similar service is provided to some public sector entities.
2. As the largest player in the market, BOJ is sometimes the only buyer to whom some entities can sell large blocks of foreign exchange if they have a need to do so.
3. The Bank also buys to proactively and steadily accumulate foreign reserves to cover its “rainy day” responsibilities. These include addressing negative or positive seasonal or other imbalances in the foreign exchange market, ensuring long-term stability in Jamaica’s international trading arrangements and also enhancing Jamaica’s ability to manage possible domestic or international economic shocks.

To fulfil these objectives, the Bank currently purchases foreign exchange via three channels: regular surrender arrangements, the public sector entity (PSE) facility, and occasional direct purchases from individual financial institutions.

The surrender facility requires all authorized dealers and cambios to sell an agreed proportion of their daily purchases to the central bank. BOJ's purchase of these funds is settled on the same day, at the new mid-day exchange rate. The previous day's weighted average selling rate (WASR) was used for settlement before the introduction of a mid-day rate.

The Bank uses the PSE facility to address the foreign exchange demand of select public sector entities. The rationale for creating this facility was to prevent large orders by these entities from unduly affecting the day-to-day operations of the market, thereby minimizing the risk of market volatility. Established in February 2009, this arrangement requires that authorised dealers and cambios surrender an additional fixed proportion of their daily US\$ purchases to the Bank. These inflows are allocated to satisfy the foreign exchange demand of public sector entities and coordinate their scheduled external payments.

On occasion, BOJ also purchases foreign exchange directly from financial institutions with excess inventories. Bank of Jamaica also sometimes buys foreign exchange from the government when large sums are received in the form of loan, grant or divestment funds.

Weaknesses of the Current Buying Mechanism:

Some of the same drawbacks of selling foreign exchange at non-market-determined rates are also drawbacks on the buying side.

When institutions are required to sell foreign exchange to BOJ at the previous day's WASR, these transactions may be either too expensive or too cheap, compared to what

individual institutions could have earned in the market. The transactions can therefore be considered by some as penal, but as profitable by others. As with the sell side, B-FXITT's multiple-price buy operation will equitably and transparently address this problem with next-day settlement on actual offer prices.

Currently, if BOJ announces an operation to buy, the impact of this intervention has to be cautiously weighed, as even with evidence of substantial reserves, the market may falsely interpret such an announcement as some sign of distress, which may create undue panic. A routine, regularly scheduled and publicly announced B-FXITT buying operation should negate this risk and normalize the process of the central bank buying foreign exchange, especially in a context where it is also selling routinely.

In addition, while the PSE facility in particular was considered a useful initiative to remove potentially distorting transactions from the foreign exchange market, it is not flexible or synchronized enough to respond proportionately if a large entity experiences a sudden change in its foreign exchange needs. Also, while it began as a safeguard mechanism to protect a shallow and fragile market, the facility came with the price of a loss of transparency, as taking these and the surrender transactions out of the mainstream market means the market rate does not reflect the entire spectrum of foreign exchange transactions.

With economic fundamentals improving and the foreign exchange market growing deeper, Jamaica is evolving towards a stage where the market is robust enough to handle these transactions without BOJ's protection, and so these government agencies can freely settle their transactions in the market without causing disruptions. **The market will therefore become more accurate and transparent by reflecting all major transactions, and daily rates will be a more accurate and credible reference of overall market activity.**

The introduction of the buying side of B-FXITT will be synchronized with the gradual reduction of surrender and PSE requirements, and over time, these requirements will be terminated. This gradual transition will see more funds available in a more dynamic and transparent market.

These pending changes mean that BOJ's standard method of buying foreign exchange will become the same efficient, market-friendly and transparent tool which it now uses to sell. BOJ will retain the right to buy or sell foreign exchange outside of the standard B-FXITT schedule at any time if extraordinary conditions warrant, but will likely utilize a B-FXITT-type operation at those times instead of bilateral transactions, which will ensure that these transactions reflect current market conditions and are settled transparently at market-determined rates. BOJ's avoidance of bilateral transactions will also benefit the market by encouraging dealers to trade more among themselves.

B-FXITT encourages changes in market behaviour to enhance market development. Modern markets should be fair to all players; buyers, sellers, and authorized traders, and so the increased efficiency, transparency and competitiveness encouraged by B-FXITT, manifested in more credible market prices, will foster a more equitable and reliable market for all.

Bank of Jamaica will notify the public when the buy-side of B-FXITT is ready. Fine-tuning and market consultations continue in the interim.

Editorial note: A slightly edited version of this article has been published in the Jamaica Gleaner: <http://jamaica-gleaner.com/article/business/20170922/b-fxitt-prescription-fine-tuning-boj-purchase-foreign-exchange>. Since the time of writing, the buy side of B-FXITT was successfully launched in March 2018 and the first buy operation executed the following month.