Brian Wynter: Stability, interest rates and economic growth

Address by Mr Brian Wynter, Governor of the Bank of Jamaica, to the Institute of Chartered Accountants' Forum, Kingston, 5 October 2011.

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Ladies and Gentlemen:

Thank you for inviting me to participate in this forum and to speak on the important issue of "Stability, Interest Rates and Growth". The topic is timely in light of Jamaica's economic history and the global financial crisis in 2008 and 2009 which is still hurting many economies, including Jamaica's. That crisis also resulted in the broadening of the mandate of many central banks to include an increasing role in facilitating sustainable growth and fostering overall financial system stability while focussing on the primary objective of price stability. In this regard, I will speak first to Jamaica's experience with growth, inflation and interest rates over the past decade and then discuss the way forward.

The Jamaican experience

The global recession during 2008 and 2009exposed the vulnerabilities in the Jamaican economy and contributed to contractions in domestic output of 3.0 per cent and 1.2 per cent in 2009 and 2010, respectively. However, while the performance in these two years was primarily the result of the global recession, economic growth before that was relatively modest, averaging 1.5 per cent per year over the previous eight years. The performance over that period was significantly weaker than that of our Caribbean neighbours and other emerging market economies, despite our relatively high rates of investment. In this regard, a number of studies have been undertaken to explain the paradox of high investment and low growth in the Jamaican economy. They all concluded that Jamaica's weak growth performance has been due largely to low productivity. This low productivity is in turn linked to under-investment in social capital given the high levels of public debt obligations.

Concurrently, over the period 2001–2010, Jamaica's annual inflation averaged 12.0 per cent, well above that of our major trading partners. This partly reflected the country's vulnerability to external and domestic shocks, including the impact of fiscal expansion and debt accumulation. The economy has been particularly vulnerable to periodic episodes of financial market and economic instability, given the persistence of large fiscal and current account deficits, in other words, the twin-deficit problem. Unsustainable public debt levels as well as the large fiscal and current account deficits contributed to bouts of exchange rate instability which impacted inflation and interest rates. This instability biased private investment decisions towards short-term, rent-seeking and portfolio hedging activities. In addition, high and variable inflation impeded growth as it was difficult for economic agents to undertake proper long-term planning. In such an inflationary and consequently unpredictable environment, it was impossible to sustain low interest rates as savers demanded a premium on their resources.

Main elements of the current economic strategy

To reverse the cycle of large fiscal deficits and unsustainable debt, the Government embarked on a comprehensive economic transformation programme beginning at the end of 2009 and supported by the International Monetary Fund and other international development partners. The objective of the programme is to secure long-term macroeconomic stability, thus creating an environment that is conducive to the low interest rates and long-term investment that are critical requirements for sustainable economic growth. The main pillars of the transformation programme are: eliminating the fiscal deficit over a four-year period and institutionalising prudent fiscal practices which will translate into sustained reductions in the debt to GDP ratio; enhancing financial system stability and creating an enabling business environment.

In the main, the Government has made a strong start to the programme, achieving most of the quantitative targets under the IMF Stand-By Agreement. This, which includes the extraordinary success of the voluntary Jamaica Debt Exchange (JDX) in February last year, contributed to a trend decline in market interest rates. From the time that a programme was agreed with IMF Staff in December 2009, Bank of Jamaica's 30-day signal rate has been reduced from 12.50 per cent then to 6.25 per cent now, a fall of 625 basis points. The rate on market-determined 180-day Treasury Bills declined even more sharply by 1,024 basis points from 16.80 per cent in December 2009 to 6.56 per cent at the most recent auction last month. Interest rates in the private money market and on deposits and loans also fell. The result is a substantially reduced cost of capital which is needed to encourage increased long-term investment and growth.

The decline in interest rates is also linked to the positive trends and outlook for inflation. Annual inflation declined to 7.8 per cent in August from 12.6 per cent a year earlier and is expected to fall further during this fiscal year to settle within the target band of 6.0 per cent to 8.0 per cent. For the medium-term, inflation is targeted to continue its fall towards the average inflation rate of our major trading partners.

Against this background and given the Bank's commitment to price stability, we have been gradually shifting our monetary policy framework towards an inflation targeting framework in order to firmly entrench the achievement of low and stable inflation as the primary objective of monetary policy. International examples have demonstrated that low and stable inflation ensures the competitiveness of the economy and contributes to sustainable growth and development.

Complementary to the Central Bank's objective of stable prices is its role of ensuring financial system stability. Fortunately for Jamaica, following the financial crisis of the mid-1990s, measures were undertaken to strengthen the financial system. These measures contributed to the Jamaican financial system remaining well capitalized and liquid throughout the recent global financial crisis. The system also remained robust during and after the JDX and as such there was no call on the emergency resources which were set aside in the Financial System Support Fund provided by the IMF. Notwithstanding this soundness, there is the need to bolster the system against systemic risks. The Government has therefore been preparing a series of legislative reforms aimed at enhancing the supervisory and regulatory framework of the financial system. These reforms are aimed at reducing systemic risks, strengthening the prudential framework of securities dealers, combatting unregulated financial schemes and improving the regulatory framework for collective investment schemes. The changes include amending the Bank of Jamaica Act to give Bank of Jamaica overall responsibility for financial stability. These reforms together with the introduction of a credit bureau will ensure that the financial system facilitates sustained economic growth.

However, for price stability and financial stability to be fully effective in underpinning growth, there must be an enabling business environment. In assessments of the business environment, Jamaica has consistently fallen short of the requisite levels. This deficiency was documented in the World Bank's 2010 Ease of Doing Business Report and the recent Global Competitiveness report for 2011–2012. To address some of these problems, the Government has introduced a comprehensive reform of the tax system aimed at reducing distortions, removing inefficiencies and stimulating growth. The reform, which was set out in the Green Paper tabled in Parliament earlier this year, will simplify the tax system, widen the tax base and improve equity mainly through the rationalization of tax waivers, exemptions and incentives. The matter is now before a committee of Parliament which began public hearings today. I am sure that given the expertise within the ICAJ, there will be helpful comments from this organisation as a contribution to this absolutely vital opportunity to set the path for a future of strong and sustained economic growth in Jamaica.

Final remarks

The current fragility in the global environment has made the prospects for strong output growth in 2011 and 2012 more daunting. However, while continued fiscal consolidation may contribute to a moderation in domestic demand, the far-reaching economic reforms that have been set in progress with exceptional levels of support from our multilateral partners will provide a foundation for lasting growth. Progress under the economic programme is already being reflected in an extended period of almost unprecedented stability in the macroeconomic environment and improving business confidence. In addition, economic growth was experienced for the first two quarters of 2011, reversing the trend decline over the previous 13 quarters.

It is worth re-emphasising that inflation is expected to be lower in the second half of the fiscal year given the projection for slower international commodity price increases, a relatively stable exchange rate and weak but improving domestic demand. Further deceleration in inflation is expected in the subsequent years. Against this background, interest rates, which have been at their lowest in almost three decades, can be expected to follow a consistent path.

Ladies and Gentlemen, the Jamaican economy is in the midst of a transition to enduring macroeconomic stability, low interest rates and sustained growth. I encourage the members of the ICAJ actively to support this process.

Thank You.