Derick Latibeaudiere: The effect of oil prices – the case of the importers

Presentation by Mr Derick Latibeaudiere, Governor of the Bank of Jamaica, at a round-table discussion during the meeting of Latin American Network of Central Banks and Finance Ministries, Washington DC, 19-20 October 2006.

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The sustained increase in oil prices since 2002 has been of tremendous concern to us in Jamaica, and it is with a great deal of relief that we welcome the most recent indications of a reversal of the trend.

The increases in oil prices since 2002 has been the most ‘shocking’ since the first major oil price jolt in the early 1970s - much beyond anything that we had anticipated. The situation in Jamaica in the 1970s was much different from what it is today. Back then, there were significant structural weaknesses in the economy, which greatly increased the country’s vulnerability to external shocks. The impact of the 1973 oil shock uncovered some of those weaknesses and made the situation much more difficult to manage. Indeed, the difficulties that we experienced following the 1973 oil shock contributed to Jamaica’s first borrowing experience with the IMF and were to a large extent responsible for the significant increase in inflation that continued to endanger our economy for the next two decades.

Things have changed since that time. The Jamaican economy has undergone significant structural and other changes and the macroeconomic fundamentals are now much better. Inflation has moderated and is now much less inimical to our economy. In addition the central bank has built a reasonable reserve cushion to help us deal with shocks of this nature.

Notwithstanding this, Jamaica like most other oil importing countries has felt the adverse effects of the persistent increases in oil prices. This has been particularly noticeable at the pumps and in our electricity rates. But despite the cumulative negative impact, the economy has remained relatively buoyant over the last two years. It is indeed true that some of the very factors that influenced the sustained increases in oil prices were also the factors that contributed to the increased investment, the growth in tourism and the demand for bauxite that Jamaica has been experiencing. These factors relate to the acceleration in world economic growth and the demand for commodities including oil, which contributed to the sharp increases in oil prices over the last four years.

For me the real concern is the effect that the increases in oil price has on inflation and also on the balance of payments. The price of oil has risen on an annual average basis by approximately 20.0 per cent between 2002 and 2005 - significantly higher than the annual average increase of 12.0 per cent between 1998 and 2001 and much more than the increases that we experienced in the 1980s and early 1990s.

Increases in oil prices have a direct impact on inflation. The price of crude oil immediately impacts electricity and gasoline. In Jamaica, electricity prices are not subsidized and therefore increases in the price of oil are passed directly to the consumer via a tariff formula that immediately adjusts the electricity rates.

Transportation accounts for the largest proportion of refined fuel sales by the domestic refinery. The consumer basket measured by the CPI only includes public transportation, (bus fares) and therefore a large segment of the major gasoline consumers are not included in the CPI. Bus fares are also administratively determined and implemented with a lag. Therefore the changes in oil prices are fed through to the CPI more slowly. In the case of cooking gas and related products these items carry relatively small weights in the Jamaican consumer basket. Consequently, although the prices are adjusted in line with the increases in external oil prices, the impact on inflation has been correspondingly small.

This brings me to the impact of the increases in oil price on **measured inflation** in Jamaica. For the four fiscal years prior the start of the oil shock, domestic inflation averaged approximately 8.0 per cent per year. For the four years after the oil shock, inflation accelerated to an average of 14.0 per cent per year. An examination of the trend in Jamaica’s inflation could, a priori, suggest that the acceleration in Jamaica’s inflation was a result of the oil shock. The evidence shows, however, that the increase in inflation over this period was related more to increases in food prices than to increases in energy related prices. The economy suffered a range of weather related shocks that caused food prices to increase significantly over this period. Therefore, the dramatic increase in oil prices was not the main factor contributing to the increase in Jamaica's inflation for that period. The effect of the sustained increase in oil prices would, however, have directly impacted those persons in the higher income groups who would not be included in the CPI.

The increases in the price of oil were felt most acutely in Jamaica's **current account**. The cost of fuel imports jumped from 6.7 per cent of GDP in FY2001/02 to about 15.0 per cent in FY2005/06. In this context, the deficit moved from a sustainable average of 5.6 per cent of GDP over the four year period 1998-2001, to an average of approximately 10.0 per cent for the period 2002-2005. The volume of fuel imports also increased at an estimated annual average rate of 3.5 per cent between FY2002/03 and FY2005/06, making for an increased dependence on oil imports.

As I have said before the ratio of Jamaica's oil imports to GDP is twice the average for the top ten oil importing counties. There are two factors that could explain this. One is the clear evidence that Jamaica's GDP is understated to the extent that the activities of the informal sector are not captured in the national accounts. Various estimates of the extent of the understatement of the GDP have converged around a figure of some 40 percent. The other factor is low efficiency in the use of fuel particularly with regard to electricity generation and its transmission and distribution. It is estimated that based on the technology currently being used in the generation of electricity (the oil-fired steam process using bunker C fuel), Jamaica loses some 70 percent per barrel of oil in the conversion process. My understanding is that other forms of technology could reduce these losses to around 50 percent. Transmission and distribution losses are in the region of 10 – 12 percent of the electricity generated relative to the world standard of 7 percent.

I now turn to **how Jamaica coped with the impact of the oil shock**, particularly the oil-induced deterioration in the current account. Private capital inflows remained buoyant and were largely responsible for the financing of the deficit. In this context, the net international reserves of the Bank of Jamaica have been maintained at an average of around 19 weeks of imported goods and services since 2002.

Remittances, which represent one of the major sources of foreign exchange inflow into the country, have also remained strong and provided a good buffer for the Jamaican economy. On a per-capita basis, Jamaica's remittance receipts are among the highest in the world, with the flows growing at an annual average rate of 16.0 per cent since FY2002/03. These flows are largely related to consumption expenditure and would therefore have helped to cushion the impact of the oil price increases on consumers.

The presence of the 'Petro-Caribe' Agreement signed between Venezuela and Jamaica also helped to mitigate some of the potential problems associated with the oil shock. The 'Petro-Caribe' Agreement provides long term financing of up to 40 per cent of the country's crude oil bill for some 20 years. It also allows for the accrued savings to be used to finance long term development projects in the country's interest.

So far, Jamaica has managed to withstand the effects of the sustained increases in the price of oil. But **what of the future**? The recent decline in oil prices to approximately US$60.0 per barrel is a welcome development that will have positive implications for both inflation and the balance of payments. Indeed, Jamaica's financial programme for fiscal year 2006/07 was predicated on oil prices averaging US$73.0 per barrel. The latest trend will make a positive difference in the achievement of our projected targets for the year. But there is no room for complacency for, intuitively, I believe that there has been an upper level shift in the equilibrium price range of oil and this is going to make a difference in how we consume oil in the years ahead.

There can be no questioning of the imperative for Jamaica to conserve and use imported fuel more efficiently. As you will all appreciate, it is not easy to adjust the amount of energy we use per unit of output, especially in the short term. The scope for reducing energy consumption is in the longer term. Jamaica's scope for the development of hydro-electricity and other forms renewable energy is limited.

Today's macroeconomic conditions are very different from those of the 1970s when we had our first oil shock. The thinking among central banks the world over has converged towards the primary objective of price stability and the moderation of inflationary expectations. Sharply increasing energy prices, with their potential to increase inflation and slow economic growth, create difficult challenges for central banks in small open economies such as my own. As a central banker in Jamaica, I count my blessings and continue to build our reserves and keep monetary policy relatively tight. The realities of the dependence on oil have sharpened my conviction on two issues – the need to maintain a competitive exchange rate and the importance of maintaining a reasonable reserve cushion.

Central banks tend to be judged by their inflation performance, yes. But I believe that even as we seek to control inflation it makes perfectly good sense for us to allow the full impact of international prices to be passed to consumers. For in doing so, we provide the incentive for them to use resources rationally - to conserve energy as much as possible and to promote the kind of long term change in oil usage and efficiency that the market mechanism encourages. This way, we avoid the over-valuation of the exchange rate and its attendant consequences for the sustainability of the current account.

My position with regard to the reserves stems from simple prudence. Jamaica's experiences in the past have convinced me of the extent of the economy's vulnerability to external shocks and other potential risks. My intention is therefore to continue to maintain Jamaica's reserves at a level comfortably above the norm. Jamaica's reserves are now equivalent to approximately 20 weeks of imported goods and services.

The nature of the world has changed and with it the economics of the global situation. We will have to live with the uncertainties in the markets. We approach them with a macroeconomic framework that is well suited to our circumstances and with a buffer of reserves that recognizes our vulnerabilities.