Brian Wynter: Modernizing Jamaica's foreign exchange market - the pivot to inflation targeting

Keynote address by Mr Brian Wynter, Governor of the Bank of Jamaica, at the 7th annual National Asset-Liability Management Americas Conference, Santiago, 25 May 2018.

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Introduction

Buenos días, Chile, Que' onda?!

Chairperson, Mr Alexandre Tombini, fellow speakers and panellists, our hosts, Central Banking Publications, colleagues, ladies and gentlemen, good morning and greetings from Jamaica.

I am happy to be here in Chile, not just for the beauty of the country or to brush up on my Spanish, but also with an ulterior motive. Bank of Jamaica is preparing to implement full-fledged inflation targeting and, given that Banco Central de Chile has been a pioneer in this area since the 1990s, we are looking forward to learning from their experience.

In addition, ***Central Banking Publications*** has been an invaluable source of information, training and networking for central bankers around the world. So I am grateful and happy to take part in an event organised by them and to have the opportunity to address this **National Asset-Liability Management Americas Conference**.

Jamaica's economic reform programme and central bank modernisation

For several years, the central bank in Jamaica has been operating an 'inflation targeting lite' policy regime. I am sure our colleagues in Chile will confirm that full-fledged inflation targeting is not something to jump into all of a sudden unless you already have the good fortune of a conducive economic environment. That environment is now emerging in Jamaica with the remarkable successes of an ambitious economic reform programme that is now beginning its sixth year.

For Jamaica to be in a position to consider adopting price stability as the central bank's primary objective and the use of the interest rate lever as its main policy tool, several things had to happen first. Since high public debt and fiscal dominance will undermine the effectiveness of any central bank, fiscal sustainability is critical to allowing the central bank the breathing space it needs to conduct an effective monetary policy. Once fiscal operations begin to crowd in the private sector and net export earnings increase, a sustainable current account balance becomes possible. Then, the political economy limitations on exchange rate flexibility in a hyper-open economy like Jamaica's diminish considerably thereby improving the central bank's ability to manage internal and external shocks. In the short space of a few recent years, Jamaica has lived through this transformation so that today we can realistically contemplate the prospect of employing modern foreign exchange market practices and full-fledged inflation targeting.

Bank of Jamaica also enhanced its forecasting and policy analysis toolkit so that it can improve the consistency of macroeconomic projections and frame sound monetary policy on a continuous basis. In July 2017, Bank of Jamaica adopted the interest rate on overnight deposits as the policy rate, replacing the interest rate on 30-day deposits. This refinement in the policy signal was intended to strengthen the transmission of monetary policy. Other refinements have included providing a system of liquidity assurance to our banks and narrowing the interest rate corridor (the difference between the overnight deposit rate and the rate on overnight advances to banks). Following these changes, the Minister of Finance in September 2017 approved a medium-term inflation target for Bank of Jamaica for the first time (the target is 4.0 to 6.0 per cent). Bank of Jamaica also enhanced policy transparency earlier this year by publishing, also for the first time, a fixed calendar of announcements of monetary policy decisions for the year ahead.

These steps, together with the measures to promote exchange rate flexibility in a modernised foreign exchange market, set the stage for an important date later this year (October) when the Government is expected to deliver on its commitment to table legislation in Parliament to modernise Jamaica's central bank. In support of the adoption of full-fledged inflation targeting, these legislative reforms will establish an independent central bank that will be accountable for maintaining price stability as its primary mandate.

Fiscal consolidation - from crowding out to crowding in

For many years, a seemingly insatiable appetite for government borrowing diverted the flow of Jamaica's financial resources from the private sector - crowding them out - and made real sector investment harder and more costly, thus impeding economic growth.

After a sustained period of disciplined fiscal consolidation, a long overdue correction, I was pleased to be in a position, in February last year, to declare without fear of contradiction that Jamaica's long history of Government crowding out had come to an end. A drastic reduction - to the point of virtual disappearance - in domestic borrowing by Government has opened the way for substantial increases in private sector credit. Private sector credit grew by 19 per cent for FY2017/18, the highest level since the economic reforms began, and should average growth in excess of 10 per cent over the medium term.

Jamaica's debt to GDP ratio in March 2018 was 103 per cent. That is, indeed, very high. But please hold on to your seats as I tell you that that is down from a high of 147 per cent in March 2013 due to the said fiscal consolidation coupled with smart debt management.

Breaking records off the track - falling inflation, falling interest rates and a falling current account balance

Say 'breaking records' and 'Jamaica' in the same breath and one immediately thinks of Jamaican athletes.

And who could blame you? After all, since Jamaica - otherwise called the 'Sprint Factory' - won its first Olympic medals in 1948, it has been the world's biggest per capita producer of quality male and female sprinters; and this long before it produced the fastest man in the history of the planet.

Like every other proud Jamaican, I am always thrilled by the extraordinary achievements of our athletes but in recent years I have had the no less extraordinary privilege of leading the central bank in a country that has been breaking records off the track - in positive economic performance.

Inflation in Jamaica has been running at 40-year-lows for the past three years. Inflation at March 2018 was 3.9 per cent, down from 13.3 per cent at March 2010. **When we experienced inflation at 4.0 per cent in March 2015, it was the lowest for a fiscal year in 48 years. But that was before we reached a new low of 3.0 per cent in March 2016, which represents the lowest fiscal year outturn since 1967.**

Against the background of this record-breaking performance, last week, Bank of Jamaica lowered the policy interest rate by 25 basis points to a new low of 2.50 per cent.

For most of its history since gaining political independence from the colonial power, Jamaica had become accustomed to significant fiscal deficits, often close to or more than 10 per cent of GDP. Now, government debt is on a steep downward trajectory. In FY2016/17, the third consecutive year of generating primary surpluses greater than 7.0 per cent of GDP, Jamaica's fiscal consolidation efforts produced a balanced budget. This is set to continue into the medium term as the debt to GDP ratio falls below 100 per cent at the end of this fiscal year on its way to meeting the fiscal rule target of not more than 60% of GDP by March 2026.

Make no mistake, ladies and gentlemen, it is rare for a central banker to have reason to blow a fiscal trumpet but the fact is that our recent successes in monetary policy have been supported by the remarkably consistent fiscal consolidation across successive political administrations. The fiscal anchor has secured the macroeconomic stability on which all our recent economic achievements have been built.

Since 2013, Jamaica has made substantial progress under an exceptionally difficult economic reform programme. Successive governments and the entire country must take credit for the effort. And we thank our many development partners, in particular, the International Monetary Fund and the Inter-American Development Bank.

The road to these historic achievements has often been difficult and painful, perhaps nowhere more evident than in the correction of a significantly overvalued exchange rate. While it was a painful transition for the country, the correction and continuing flexibility of the exchange rate helped to restore the external price competitiveness that we had lost in the preceding years. The exchange rate is now broadly assessed to be fairly valued, reflected in the strong performance of Jamaica's external accounts.

The external accounts indicate that, for the first time in its independent history and in the lifetime of most Jamaicans, Jamaica is sustainably earning enough to

pay its bills without the indulgence of perpetual borrowing. The current account deficit is projected to remain sustainable over the medium-term. **FY2017/18 was the third year in a row where current account transactions placed no net pressure on the foreign exchange market. This has not occurred since the early 1960's.**

B-FXITT and the making of a modern FX market

As with inflation and the fiscal accounts, a new era has begun for Jamaica's foreign exchange market.

Bank of Jamaica introduced a new tool called the **Bank of Jamaica Foreign Exchange Intervention and Trading Tool (B-FXITT)** in July 2017. B-FXITT is a series of measures centred on rules-based, competitive, multiple-price auctions for the central bank's transactions with intermediaries in the foreign exchange market. We started first with sale auctions which provided market participants with reassurance about the availability of future supplies of foreign exchange. With the first stage successfully concluded, Bank of Jamaica then introduced competitive buy operations in April 2018.

A key feature of B-FXITT is that the amounts for buy and sell auctions are announced four weeks in advance. The auction rules are designed to ensure equitable access for all qualified participants, which helps to make smaller dealers more competitive and puts pressure on larger dealers to improve their margins and the quality of their service in order to retain market share. Additional measures will be implemented to improve the quality of services delivered to end users by foreign exchange dealers. This will include the adoption of an FX market code of conduct governing the behaviour of dealers in their interactions with each other and with their customers.

Thanks to adequate supplies from improved earnings in a sustainable current account balance, **the foreign exchange market has finally evolved from a state of almost continuous movement in one direction only to a more normal two-way market where the exchange rate is just as likely to move up as it is to move down**. Exchange rate movements over the medium-term more reliably reflect changing economic and market conditions without hidden distortions.

This new reality and the longer-term stability that it has brought puts banks and other financial institutions in a better position to offer reasonably priced hedging tools to businesses that may not have the capacity to manage the increased daily exchange rate volatility. The generally less risky environment coupled with greater transparency in the FX market has opened up opportunities for a variety of risk mitigation products to be introduced. Ensuring that this happens is the focus of our current efforts.

As other countries have experienced, we expect that adequate supplies of foreign exchange and a significantly reduced exchange rate impact on inflation will over time weaken the historical focus of the public on the exchange rate as a key measure of overall economic performance and the primary indicator of future inflation. The central bank's primary focus on low inflation will take centre stage as it gradually reduces its footprint in the foreign exchange market.

This modernization of the foreign exchange market, in the context of the overall economic reform programme, is now providing the pivot towards our goal of price stability within an inflation targeting regime.

Conclusion

Ladies and gentlemen, despite being an unqualified success to date, economic reform for Jamaica has not been easy and many challenges remain, including a stubbornly sluggish growth rate held back by low productivity. In addition, there are special risks associated with being a small hyper-open economy located in the middle of the hurricane belt. Yet, our achievements to date give us confidence that we can plan for the future from a position of increasing strength.

The simple truth, ladies and gentlemen, is that Jamaica's prospects have not looked this good since the days of political independence in 1962 and this allows us to be confident in our ambition to achieve economic independence.

Indeed, at this point I am as confident as the celebrated Chilean poet, Pablo Neruda, when he declared,

" - you can cut all the flowers, but you cannot keep Spring from coming."

Jamaica's economic spring is on the horizon.

Gracias, ladies and gentlemen.