BANK OF JAMAICA

GOVERNMENT OF JAMAICA

JAMAICA DEBT EXCHANGE

Prepared Remarks

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Good morning.

I am going to begin by outlining the importance of this transaction and locating it in the context of monetary policy and financial system stability. Then I will outline the monetary and balance of payments elements of the Economic Programme and end by describing briefly some policy actions that the Bank of Jamaica will take during and in the period immediately following the transaction.

This transaction, along with fiscal reform and the support packages from the International Monetary Fund and other multilateral financial institutions, is essential for the economic well being of the country. As you have heard, the Government's programme to reduce the cost of the debt is an integral part of the medium-term reform plan to reverse fiscal imbalances and the unsustainability of Government debt. The successful completion of the debt exchange is a prior action under the Standby Agreement being negotiated with the IMF. Furthermore, in a context where the external credit markets remain virtually closed to us, the signing of the Agreement with the IMF is critical for the success of the Government's medium-term economic programme. The Agreement will result in financing from multilateral sources to the tune of US$2.4 billion which will be received over the next two years.

As is well known, the implementation of monetary policy over the years has been challenging for a number of reasons. But our primary target of sustained low inflation, underpinned by exchange rate stability, has been most directly and severely tested by large and protracted fiscal deficits and unsustainable debt dynamics. Against this background, the Bank has had to utilize its interest rate tool to stabilise episodes of financial market volatility that were induced by investor uncertainty regarding the Government's ability to meet its substantial domestic and external financing needs. The successful completion of this debt transaction will set us on a robust path towards the elimination of this fiscal dominance over monetary policy and thereby minimise the attendant risks of balance of payments and price level instability.

In summary, we are confident that the debt exchange and entrenchment of fiscal discipline will facilitate monetary management going forward.

Equally important is the Bank's mandate to preserve financial system stability for the benefit of all members of the society. One of the requirements for financial system stability is a framework which guarantees fiscal prudence over the medium term. The debt exchange, as well as the introduction of a Fiscal Responsibility Framework and the establishment of a Central Treasury Management System for the Government early in the next fiscal year, are aimed at reversing the adverse cycle of higher borrowing costs and deteriorating fiscal balances that has led, in the past, to episodes of severe financial market pressure. Re-establishing and maintaining fiscal and debt sustainability will reduce sovereign risk premiums and facilitate and encourage private sector investment, thus helping to create the underlying conditions for robust economic growth. Jamaica's medium-term programme has also been designed to facilitate the necessary structural reforms that will further strengthen the financial system.

With respect to the effects of the transaction itself, the Bank has given top priority over the past several months to the preservation of the stability of the overall financial system. The Bank's technical team reviewed the debt exchange offer in detail and we are satisfied that it has been developed in a prudent and balanced fashion. Our team, together with technical experts at the IMF, have run various stress tests on the financial system and have conducted detailed and extensive simulations, inclusive of the expected income and fair-value losses of financial institutions and other potential 'knock on' effects associated with the transaction. Contingent on an orderly debt exchange and firm cooperation with regulators, we believe that the temporary impact on financial institutions' profitability and their capital adequacy will be manageable. We are also resolved to preserve the overall stability of the financial system.

Before the Financial Secretary presents the material benefits to fiscal and debt dynamics that will arise from the debt exchange offer, let me now highlight key elements of the monetary programme set out in the Letter of Intent to the IMF.

Monetary and Exchange Rate Policy

The economic programme, as set out in the Letter of Intent, will focus on reducing inflation and preserving a stable real exchange rate over the medium term. In this context:

Headline inflation is expected to decline gradually over the medium term, falling below 7.0 per cent by FY2013/14. Notwithstanding a temporary increase in inflation this fiscal year (2009/10), resulting from the introduction of new tax measures, the reduction in debt service costs will substantially temper inflationary pressures. This will allow monetary policy to continue to focus on bringing inflation to the 5-6 per cent range as quickly as possible.

The balance of payments is projected to improve significantly over the medium term. Supported by fiscal consolidation, the current account deficit is expected to narrow to about 9.0 per cent of GDP in FY2010/11 from about 10.5 per cent in FY 2009/10 and, further, to 4-5 per cent of GDP over the medium term. This improvement, coupled with a projected recovery in foreign direct investment, will result in overall balance of payments surpluses beginning in FY 2011/12.

Gross international reserves are targeted to rise to around 16 weeks of goods and services imports over the medium term from 12 weeks of goods and services imports projected for end FY 2009/10. Given the projections for the balance of payments, this target implies that for the period FY2010/11 to FY2013/14 there will be a financing shortfall of about US$790 million. This gap can be adequately financed by the Standby Facility, which will help to support a stable foreign exchange market. Against this background, the compression in interest spreads between domestic and foreign currency Government of Jamaica bonds arising from the debt exchange will still preserve relative attractiveness of domestic currency instruments to investors and we expect that this will be sustained over the medium term.

<u>BOJ Policy Actions During and After Transaction</u>

Turning now to policy actions by the Bank of Jamaica during and in the period immediately after the transaction, I indicated earlier that the debt exchange has been carefully designed to preserve the stability of the financial system. However, it is possible that the situation of individual institutions could change over time, especially as interest rates and inflation will continue to fall as the programme is implemented. In recognition of this possibility, the Government has established as part of the multilateral package a special line of support for domestic financial institutions. This new facility, the Financial System Support Facility, will be administered by the Bank on behalf of the Government, and the form of support will be repo-based funding. No haircuts will apply so that eligible entities can borrow up to 100% of the nominal amount of Government bonds pledged. Provided they have supported this transaction with 100% of their bonds, financial institutions regulated by the Bank, as well as those not regulated by the Bank, may participate in the facility.

The Bank's normal liquidity support to commercial banks will also be available as a last resort but, as is well understood by financial institutions, this type of support is not available to the wider financial sector, is provided strictly at the Bank's discretion and, in accordance with the Bank's governing statute, may only be provided against collateral with a significant haircut. Institutions which continue to hold the Old Bonds should also understand clearly that the liquidity of those instruments, already in most cases quite limited, will be severely curtailed and that the Bank expects to take this into consideration when determining their adequacy as collateral.

The Bank also believes that fiscal and debt dynamics, after completion of the debt exchange, will improve significantly and will warrant an entirely different yield curve. Consistent with this belief and in order to remove potential market distortions during the transition period, the Bank has temporarily removed tenors over 30 days from its open market operations. This will allow for the smooth establishment of a new yield curve on BOJ certificates of deposit following the debt exchange that is consistent with the improved fiscal and debt paths of the Government.

Conclusion

Understandably, you may want to discuss this transaction and the specific circumstances of your institution further. Our technical teams are at hand to assist with any matters that may arise and I, personally, will be available to discuss this matter with any of you wishing to do so. In the final analysis the Bank of Jamaica will be depending on your support for this very important element of the medium term programme that is designed to move Jamaica forward.

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