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OPENING ADDRESS

INFLATION AND THE PENSIONER

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Ladies and Gentlemen: Thank you for the opportunity to speak to such a distinguished group of persons. I am, indeed, very happy to be here as it gives me an opportunity to engage you on the issue of inflation that is central to your financial planning and which is of even greater significance for those on a fixed income. In my job, I spend a lot of time thinking about inflation and how to keep it down. I have come to believe that a major contributor to countries with long records of low inflation is the existence of a societal consensus about how little of it is desirable and how much of it is tolerable. As a contribution to the process of forging this consensus, I would like this morning to talk to you about the factors that affect inflation and how it affects you as pensioners.

Jamaica is referred to as a medium to high inflation country. Over the years, we have experienced volatile and high inflation that has affected our ability to plan effectively and to estimate ahead of time what the real rate of return on our savings and investments is likely to be. So, what do we understand about inflation? In the simplest terms, inflation is the continuous increase in the general price level of the goods and services that you consume. In Jamaica, inflation is primarily driven by the cost of food and energy. In fact, these items contribute to more than half of the items in the basket of goods and services consumed by the average Jamaican.

Inflation in Jamaica is typically caused by four main factors. These are **imported inflation**, which is quite significant because of the openness of the Jamaican economy;

the **flexibility of the exchange rate**; the **absence of subsidies and price controls** and a **monopolistic market structure**, particularly for energy.

A very large portion of the goods we consume and use in our production processes are **imported**. Indeed, the major component in our production processes is oil-based energy; energy from oil that we do not produce and that is subject to large price swings triggered by random events in far off places. Similarly, we are highly dependent on imported grains for the production of our food. This dependence on imported goods makes Jamaica highly vulnerable to changes in the prices of these commodities.

Turning to the impact of the **exchange rate** on inflation, it is very well understood by everybody that, given Jamaica's high propensity to import, any significant depreciation in the exchange rate will contribute to increases in the prices being faced by producers and consumers. In late 2008 to early 2009, a sharp depreciation in the value of the domestic currency contributed to an increase in prices for imported commodities. Recently, we have been observing a general appreciation in the value of the Jamaica Dollar largely due to investors' confidence that the macroeconomic fundamentals are improving. Ultimately, this should translate into lower and more stable prices for consumers.

Expectations (sometimes called inflation inertia) play a significant role in determining Jamaica's level of inflation. If we continue to have high and volatile inflation year after year, the public will build these high levels of inflation into their planning horizons. This is done, for example, by demanding higher wages in an effort to maintain purchasing power or by setting higher mark-ups on goods and services in an effort to maintain profit levels. These actions serve to hold back or prevent downward price adjustments and magnify the pass-through of exchange rate depreciations.

Jamaica's inflation experience is also influenced by **shocks** - either domestic or international. Because of its geographic location, Jamaica is vulnerable to seasonal weather-related shocks such as hurricanes and floods. Most of the weather-related shocks affect agricultural supplies. Given the strong weight of food in the consumer basket, these shocks have a significant impact on inflation. Other shocks include adjustments to government's tax policy or fare increases granted to the transportation sector.

Of course, where price developments are being dominated by random shocks or tax policy, the central bank can do little or nothing about the direct impact. Its conduct of monetary policy does, however, go a far way in limiting the persistence of such shocks by conditioning expectations and smoothing what is called "monetary" or "core" inflation. Accordingly, the Bank regulates the supply of money and credit in the economy in order to achieve a level that is conducive in the circumstances to low or moderated price increases. In addition, and quite importantly, the Bank communicates its view of emerging macroeconomic conditions as an equally accessible guide to all economic agents.

For this fiscal year, 2010/2011, the Bank of Jamaica is forecasting that inflation will fall in the range 7.5 to 9.5 per cent, a significant improvement over the out-turn in recent years. With the slow recovery in the global economy, international commodity prices are expected to be well contained. In addition, the value of the Jamaican Dollar is expected to remain relatively stable. Further, recent surveys have indicated that inflation expectations have been abating, suggesting that businesses are becoming convinced that the inflation objective will be met. We are also expecting that there will continue to be excess capacity in the economy as demand remains low. In this context, we are currently forecasting that inflation for the year will end up being close to the bottom of the range.

For the medium term, the economic programme envisions that the rate of inflation should fall to about 6.0 per cent a year by FY2013/14. This is based on relative stability in the prices of international commodities and in the value of the Jamaican Dollar. We are projecting moderate growth in money supply and credit such that real economic activity can expand in the range of 2.0 to 3.0 per cent in the medium term. The outlook is also contingent on the fiscal accounts performing as outlined in the economic programme, that is, a gradual reduction in the fiscal deficit followed by fiscal surpluses in the medium term.

Why should Jamaica be happy with inflation of 6.0 per cent in the medium term when most of our major trading partners have annual inflation rates of 3.0 per cent and below? I have my own clear views on the answer to this question but I do not propose to share them with you this morning as my aim is to provoke debate rather than to argue for a particular point of view. No one person can claim to possess the "truth" when it comes to determining the desirable rate of inflation. It is not a question that can be left solely to technocrats. Neither, in my view, should it be a question solely for politicians. More important, I would like to propose, is that we should seek to identify or uncover the societal consensus on inflation, and if there isn't one, then we should join together to take the necessary steps to forge one.

Why have I said all of this? I want to help you as pensioners to understand the issues around inflation and to invite you to lend your support to those reforms and institutional arrangements that contribute to a lower and more stable inflation environment. Given the low interest rate environment that has ensued following the successful completion of the Jamaica Debt Exchange and the signing of the Standby Agreement with the IMF, the maintenance of low investment-friendly inflation is a necessity if your financial planning is to bear any real fruit. As inflation becomes low and stable you can be more comfortably in your expectation that the returns on your investments will be more stable and your income in retirement will maintain its purchasing power. Businesses will be able to plan with greater certainty thereby minimising the volatility in consumer prices that stem from the productive process. And you can plan to enjoy your retirement years in a more relaxed frame of mind.

Ladies and Gentlemen, the economic environment is challenging for the world in general. The global economy is slowly recovering from the most severe economic crisis since the Great Depression in the first half of the Twentieth Century, ie, nearly a whole century ago. Jamaica was deeply affected. The experience has forced us to reassess our situation and to take urgent and painful steps to place the economy on a sustainable path with low interest rates and stable growth in output, facilitated by low and predictable inflation. We will be depending on your continued support as we seek to provide the foundation for a strong and resilient economy.

Thank you.