BANK OF JAMAICA

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The Net International Reserves of the Bank of Jamaica: The Realities

(Speech given by Governor Derick Latibeaudiere at the Life of Jamaica "High Flyers Club" Luncheon on Wednesday, October 11th, 2006 at 12:30 p.m. at <u>The Jamaica Pegasus Hotel)</u>

Mr. President, Senior Executives of Life of Jamaica, Members of the High Flyer's Club, Ladies and Gentlemen,

Let me say special thanks for inviting me to address you today on a matter that is of particular importance to all of us in this country – the Net International Reserves of the Bank of Jamaica – the life-support of our economy and the country's insurance cover against adversity. It is a pleasure for me to be here.

I know that you have some specific questions that you would like me to address but I shall be taking a more general approach and I hope that the answers to your questions will become clear as we go along.

Some 30 years ago when I started to focus in earnest on economic policy management, '*The Monetary Approach to the Balance of Payments*' was required reading for anyone in this line of work. After years of being closely associated with IMF dogma, the 'approach' might have lost some of its lustre. But for those of us who were schooled in its method, it left an indelible mark. It explained in a simple, consistent way that the bottom line of a country's balance of payments in any given period, was exactly equal to the change in the net foreign assets of the central bank during that same period. In other words, the accumulation of reserves in any given period is the difference between the total inflows and outflows of foreign currency during that same period.

Straightforward in an accounting sense, yes. But the underlying implications of the 'approach' were important. The 'approach' implied that the mix of monetary and exchange rate policies that leads to an improvement in the central bank's foreign assets would also be consistent with improvements in the country's balance of payments. The ‘approach’ further implied that by developing mechanisms to manage base money and limit central bank credit to the public sector, we could effectively programme and monitor quite closely, a set of desired macroeconomic outcomes.

In real life, the process is never that smooth or mechanical. There are always unpredictable changes in commodity prices and supplies which vary the pattern of earnings and payments on the current account. Even more unpredictable are the shocks to expectations, which affect portfolio behaviour and the pattern of capital flows. These shocks inevitably affect the bottom line. Therefore, if the reserve cushion is thin or non-existent – as we have experienced in Jamaica – a shock from whatever source would determine whether we succeed or fail in the achievement of our macroeconomic targets. Jamaica’s accumulation of reserves is thus a deliberate policy objective.

Over the last ten years, the country’s net international reserves have moved from US$496 million in March 1996 to US$2.3 billion at the end of September 2006. Let me pause here to reflect a little on where we are coming from. Some of you will recall that there was a long period when the economy experienced severe difficulties because we had no reserves. Indeed, I distinctly remember the occasions when ships with their cargo of oil to discharge would be waiting in the harbour to be assured of payment. I also recall that for an extended period up to the early 1990s, Jamaica had to resort to the IMF for balance of payments support because we had no reserves. The amounts that we were borrowing at the time were relatively small and were delivered in tranches of about US$13 million per quarter dependent on whether or not the country’s macroeconomic performance satisfied the conditionalities of the IMF. Compare this now with our ability to comfortably sell upwards of US$20 million to the foreign exchange market on any given day.

Ladies and gentlemen, the improvement in the reserves is no small achievement. It has allowed us to survive severe external shocks, to cope with shifts in investor confidence and to weather the storms - overcoming as we have, the many acts of God that have tested us. Progressively, the accumulation of reserves continues to raise our profile in the international capital markets.

But what is the source of these reserves?

The Bank of Jamaica buys foreign exchange from exporters of goods and services, from Government, from investors and, in general, from any entity that wishes to acquire Jamaica Dollar assets or settle obligations. Most of these purchases are intermediated by commercial banks and authorised dealers who themselves have customers who demand foreign exchange. Consequently, only the excess is sold to the central bank.

The funds purchased by the central bank are owned by the Bank of Jamaica and are managed in accordance with the highest international standards governing national reserves. If conditions warrant, the funds are available to be sold to the market. The reserves therefore represent the force that underwrites stability in the financial markets. The reserves also assure the convertibility of investments and the stock of blue chip assets that raises the international credit worthiness of residents, both corporate and private. The NIR is the ultimate form of a contingency arrangement for the country.

People have often questioned whether the reserves could not be used to facilitate other development objectives more directly. The answer is simply that there are no mechanisms for transferring the reserves to the Government once they have been purchased by the Bank. As I said earlier, the reserves are for emergencies. But beyond that, the use of the reserves for other purposes is fraught with danger. Reserves that are tied to projects or used to guarantee borrowings can no longer be considered reserves in the true sense, for in the jargon of the trade, they have been hypothecated. We have seen how the creative use of reserves helped to destabilize the economies of South East Asia in particular Thailand, Malaysia and Indonesia in the late 1990s. I would not want to be responsible for any decision that would lead the country in this direction.

Let me now turn to the matter of the adequacy of reserves. In discussing this issue, I would argue that there are degrees of comfort at various levels of reserves, and that in general, for a country like Jamaica at this time, the degree of comfort increases as we augment our reserves. This is not to say that a time will not come when we believe that we would have achieved the optimum level of reserves, but we are not there yet.

The adequacy of reserves is a function of both necessity and perception. The potential risks define the necessity and influence the perception. In the eyes of an investor for instance, the reserves of a country are not adequate until the investing public (including the international community) perceives them as being sufficient to cushion the risks that could arise. The comfort level of reserves therefore relates not just to the current situation but also takes account of the future.

In determining an appropriate level of reserves, central banks consider a range of factors. These include vulnerability to shocks, the strength of the fiscal and financial sectors, the current account balance, the composition of capital flows and the level of debt. In this context, an adequate level of reserves is one that satisfies some minimum desired precautionary balance, given that higher levels will be more costly to the economy. The cost of holding this minimum precautionary stock is the country’s “insurance premium”.

The rule of thumb employed by many analysts is that the reserves should be sufficient to pay for twelve weeks of imports of goods and services. By this measure Jamaica's reserves are now in a reasonable comfort zone, with gross reserves (September 2006), representing approximately 19 weeks of imports of goods and services. You will have noticed that the Bank of Jamaica publishes its observance of this reserve standard in our monthly bulletin on reserve levels, carried in the local newspapers and on the BOJ website.

With the growth of capital flows to emerging markets especially during the 1990s, there has been a change in the way the world looks at reserves. Indeed, higher standards for reserve adequacy have become necessary in order to provide confidence to the markets that external obligations can be met. In particular, a country's reserve holdings represent an implicit guarantee that sovereign debt will continue to be serviced even in situations where access to new borrowing may be curtailed or become very costly.

As is the case with any insurance coverage, the holding of reserves is not without costs. The boost to the domestic money supply that derives from the overall reserve accumulation has to be sterilised by the central bank through the sale of domestic securities. If the interest rates on these securities are higher than the rates at which the reserves are invested, then there is a net cost to the central bank of holding the reserves. These costs are often the subject of discussion in Jamaica. However, as I have outlined earlier they are clearly related to the benefits that we all derive from the maintenance of macroeconomic stability and the achievement of a respectable profile in the international markets.

Apart from the cost, there is a view that the holding of large reserves can affect a country's willingness to adjust to changing circumstances. The argument is that huge reserves could induce laxity in macroeconomic policies including an over-extended defence of an exchange rate regime, by removing the external constraints on policy choices. In other words, it is possible to accumulate too much reserves. In our case, the exchange rate is market determined and the Bank intervenes only where there is disorder in the market. Thus, while we build the reserves as a buffer against potential crises, we are ever mindful of the need to balance the policy choices.

I now turn to the matter of the risk, relative to the coverage.

The assessment of risk has advanced in leaps and bounds since the acceptance of the twelve-week-of-imports standard for reserve coverage. The adequacy of the reserves must now take account of the potential calls on funds and the mobility of capital in an integrated financial market. One measure of adequacy that is now espoused by rating agencies is the juxtaposition of short term debt (due within one year) with the availability of reserves. If we use this measure, Jamaica's short term debt payments in 2005 were approximately US$900.0 million relative to its average reserve holdings of approximately US$2.1 billion during the year. For 2006, the corresponding estimates are US$640.0 million for short term debt relative to average reserve holdings of US$2.4 billion. So far, so good.

Recent research by the Bank has indicated that we are proceeding in the right direction and that there is still room for the reserves to grow. In a context where global interest rates are rising there is always the potential for shifts in investor sentiments. The Bank's objective is to continue to insulate Jamaica against any possible emergency by enhancing the reserve cover and maintaining the safety and integrity of the financial system.

But underlying all of this is the need for the country to sustain an environment in which investors can be comfortable. This can only be achieved by curtailing inflation expectations, maintaining a competitive real rate of return on Jamaica dollar assets, and ensuring that the macro-economy remains stable. If while we seek to achieve these objectives the unexpected happens, then you can count on us to have the reserves.

Thank you.