MONETARY POLICY MANAGEMENT

IN JAMAICA

MONETARY POLICY MANAGEMENT

IN JAMAICA

compiled by

Monetary Policy Communication Unit

Preface

The Bank of Jamaica has undertaken to publish a series of pamphlets on topics that are integral to the policies and operations of the Bank. The pamphlets are designed to enhance the public's understanding of key central banking issues. In this regard the pamphlets will present important economic and financial information in a manner that will benefit a wide cross-section of users.

In particular, it is anticipated that the material presented will assist journalists, investors, students and other members of the public who frequently request relevant documentation and/or explanations from officers of the Bank. The Bank and its staff in continuing to serve the Jamaican public are pleased to add these pamphlets to existing publications as we strive to inform and educate.

Discussions on economic policy in Jamaica often focus on interest rates and the exchange rate because changes in these prices play a critical role in the decisions that people make about saving and investing. Money and credit conditions also influence inflation and therefore, are important determinants of the quality of life of Jamaicans. Bank of Jamaica is the institution that manages these conditions with the objective of keeping inflation low and stable. The specific targets that the Bank sets and the actions that it takes towards meeting these targets are described as monetary policy.

This pamphlet provides information on how monetary policy is determined and managed in Jamaica. It examines the issues and illustrates how monetary policy affects the Jamaican economy. Explanations are also provided for the technical terms frequently used in relation to monetary policy.

Acknowledgments

We take this opportunity to extend our gratitude to all who have supported the process of putting this pamphlet together.

CONTENTS

What is Monetary Policy?

Under the Bank of Jamaica (Amendment) Act, 2020 passed by both Houses of Parliament in December 2020 and brought into effect on 16 April 2021, the primary objective of the Bank is the maintenance of price stability. The amended law enshrines inflation targeting as the monetary policy framework to be used by the Bank to achieve price stability.

Bank of Jamaica's monetary policy objective is to achieve a continuous inflation target of 4.0 per cent to 6.0 per cent. Inflation at this level, measured as the change in the consumer price index that is published by the Statistical Institute of Jamaica, will facilitate sustained growth and development in Jamaica. The Bank uses monetary policy instruments or tools to meet its inflation target, the main one being the interest rate paid on overnight balances in the current accounts of deposit-taking institutions held at the central bank.

In Jamaica, monetary policy is focused on maintaining low, stable and predictable inflation. This low, stable and predictable inflation allows households and businesses to confidently plan for future consumption, production, savings and investment. This supports the achievement of high GDP growth and low employment in the long run.

Monetary Policy and Inflation

The Bank's monetary policy actions are aimed at achieving the objective of a medium-term inflation target of 4.0 per cent to 6.0 per cent. This inflation target was initially set by the Minister of Finance and the Public Service in consultation with Bank of Jamaica in September 2017.

The current inflation target was set to facilitate growth, particularly against the background of significant fiscal and structural reforms which have been undertaken in recent years under the country's economic reform programme.

Most central banks around the world target a single inflation rate, including the Bank of Canada, the European Central Bank and the Bank of England which have an inflation target of 2.0 per cent. However, Bank of Jamaica targets inflation within a range in order to allow for some flexibility of movement in the inflation rate, particularly given our vulnerability to external shocks such as volatile international crude oil prices and adverse weather conditions including hurricanes and droughts.

An important element of Bank of Jamaica's monetary policy framework is a flexible exchange rate. This flexible or free-floating exchange rate is a necessary component of inflation targeting as it allows the Bank to pursue independent monetary policy that is most appropriate for Jamaica's economic circumstances. If Bank of Jamaica were to try to manage or control the exchange rate within an open trade economy, it would lose its ability to set monetary policy, as the level of interest rates that would be required to stabilize the exchange rate would be dependent on the level of interest rates abroad and not on domestic economic conditions. Movements in the exchange rate also act as a buffer which assists in allowing the economy to absorb internal and external shocks.

Why is low, stable and predictable inflation important?

Maintaining stable prices in an economy means that the changes in the prices of goods and services are small and predictable, which in turn reduces the level of uncertainty among households and businesses when making decisions.

High and very volatile inflation affects people such as pensioners and fixed income earners whose incomes do not rise as rapidly as prices. Therefore, the same amount of money will purchase less goods and services in a high inflation environment.

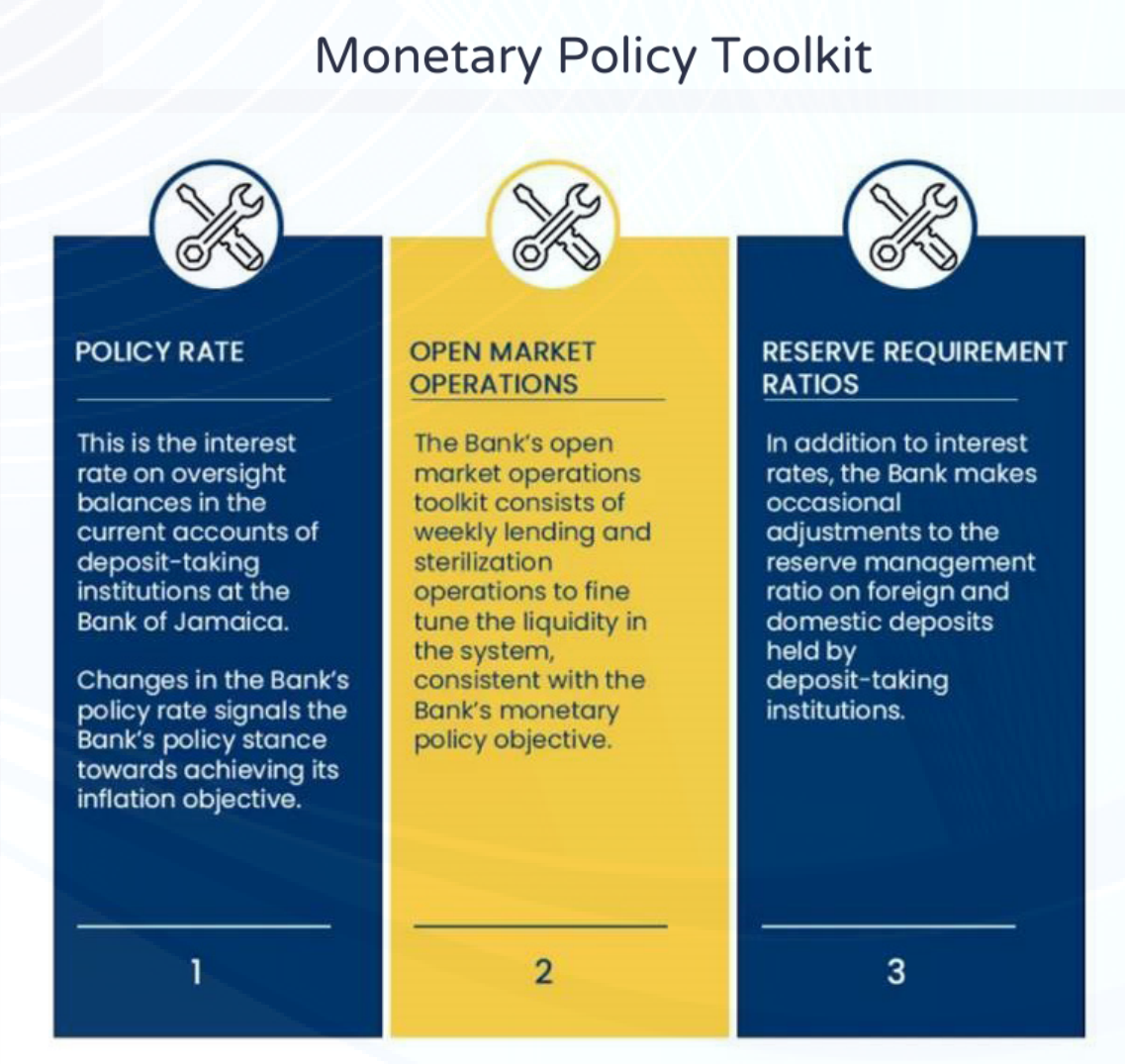
High and very volatile inflation affects people who save or lend at an interest rate that is lower than the inflation rate. This causes then to suffer from a loss of purchasing power over time.

High and very volatile inflation affects the certainty of the environment for business planning. For example, a businessman may find it hard to decide whether he should invest now, or delay the purchase of a new machine when he faces the possibility of prices rising sharply and unpredictably. Further, he will also have difficulty in defining the time path of the cost of inputs and the price at which he should sell the final good/service he produces when inflation is high and volatile.

High and very volatile inflation affects individuals' expectations of price increases and anticipatory defensive price adjustments (e.g. wages and prices being set in anticipation of future wage and price increases). This situation develops into what is called an inflation spiral where inflation literally feeds on itself and becomes self- perpetuating.

Monetary Policy Instruments

Bank of Jamaica uses a variety of tools or instruments to achieve its inflation target. The Bank's main monetary policy tool is its policy or signal interest rate. Changes in the Bank's policy rate signals the Bank's policy stance towards achieving its inflation objective. Bank of Jamaica also conducts open market operations and makes occasional adjustments to the reserve requirements ratios, while overseeing the operations of the foreign exchange market.



• *BOJ's Policy Interest Rate*

The main monetary policy tool used by Bank of Jamaica is the policy interest rate. The policy interest rate is the interest rate that the central bank pays on balances in the current accounts of deposit-taking institutions at Bank of Jamaica. Changes in the Bank's policy rate signals the Bank's monetary policy stance towards achieving its inflation objective, which is transmitted to prices through the financial markets and then through spending and investment decisions. When the Central Bank wants to tighten monetary policy (contractionary monetary policy), it will increase the interest rate it pays on these deposits and it will lower the policy rate when it wants to loosen or expand monetary policy.

Bank of Jamaica established an interest rate corridor which defines a band within which short-term money market rates are expected to move. The floor of the corridor is the Bank's policy rate while the ceiling of the corridor is the interest rate on the Bank's standing liquidity facility (SLF). The SLF is an overnight facility implemented to assist deposit-taking institutions with short-term liquidity needs.

The lower bound of the corridor represents the lowest rate at which banks should lend excess funds to the market, while the upper bound of the corridor represents a ceiling for the rate at which banks should borrow in the money market. The ceiling of the corridor is determined as a spread over the policy rate.

The Bank has reduced the policy rate significantly in the last few years (historical data). In response, deposit-taking institutions - that is, commercial banks, merchant banks and building societies (or DTI's for short) – have recorded strong growth in loans as well as marked reductions in lending rates on local currency loans.

• *Open Market Operations*

Bank of Jamaica's open market operations (OMO) toolkit consists of weekly lending and sterilization operations to fine tune liquidity in the system, consistent with the Bank's monetary policy objective. OMOs influence short-term money market interest rates to affect both Jamaican dollar and US dollar liquidity in the financial system. The aim of these OMO facilities is to provide liquidity assurance to the financial system and to concurrently strengthen the monetary policy transmission process. Some of these instruments include:

- The 14-day repurchase agreement (repo), a liquidity injection instrument which is offered once per week to DTIs on a competitive auction;
- The 30-day Certificate of Deposit (CD), a liquidity absorbing instrument, is also offered once per week to primary dealers and DTIs in fixed volumes via competitive multiple-price auctions.
- Periodical lending and borrowing operations for periods outside of these standard facilities, which are usually geared towards the achievement of other specific objectives.

• *Reserve Requirement Ratios*

In addition to the tools mentioned above, the Bank makes occasional adjustments to the reserve requirement ratio. DTIs are required to hold a certain level of reserves (cash) against specified domestic and foreign currency liabilities (deposits) at Bank of Jamaica. Adjustments to the domestic or foreign currency cash reserve requirements not only serve as a monetary policy instrument to influence liquidity conditions, they are also a prudential and safety net tool in the event of sudden withdrawals.

Communication

The Bank is committed to a communication strategy aimed at enhancing policy transparency. The Bank publishes a calendar of monetary policy announcements each calendar year which can be viewed on the Bank's website *(see Monetary Policy Schedule)*. The policy decisions are accompanied by a press statement and press conferences which indicate the rationale for the decision. The press conferences are held four times for the year.

A key element of the Bank's communication strategy is the publication of its Quarterly Monetary Policy Report (QMPR) which is also published four times each year. The report discusses, in a non-technical manner, economic developments for the review quarter and provides forecasts of key macroeconomic variables, including inflation.

Bank of Jamaica has also established social media accounts such as Twitter, Facebook and YouTube to expand its outreach. The Bank communicates on radio and television through its "Centrally Speaking" and "Inflation Watch" series as well as through advertisement campaigns to sensitize the public about economic issues via print and electronic media. Other initiatives include town-hall meetings and other seminars aimed at educating the public about inflation related issues.

It is critical that the Bank maintains clear communication with the public to preserve the credibility of the Central bank and anchor inflation expectations to Bank of Jamaica's inflation target.

Monetary Policy Transmission

Monetary policy decisions affect the economy and inflation through a process called the monetary policy transmission mechanism. This describes the process through which changes in the central bank's policy tools are transmitted through the financial system via financial prices and quantities to the real economy, affecting aggregate spending decisions of households and firms, and hence inflation.

Since the mid-1990s, Bank of Jamaica has intensified its efforts at measuring, analysing and explaining the transmission mechanism. With changes in the economy and the inflation stance of the authorities, the length and strength of the transmission process can change over time. There are three main channels through which monetary policy actions can affect inflation, these are the credit channel, the exchange rate channel and inflation expectations.

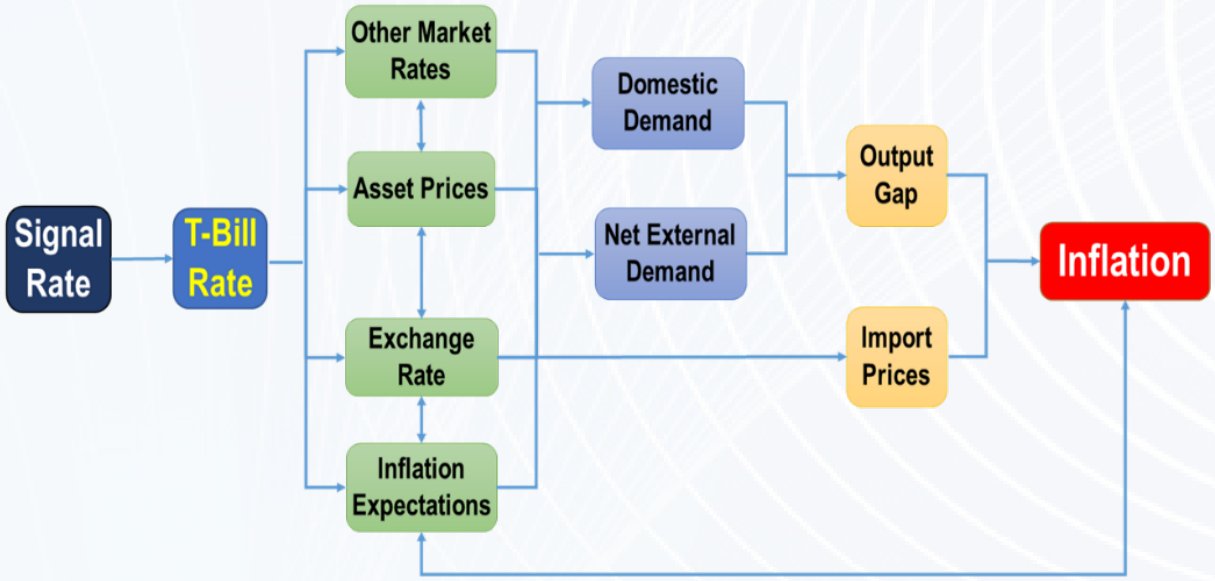
- The **credit channel** shows the effect that changes in the policy rate has on interest rates offered by DTIs, including mortgage rates, consumer loan rates as well as deposit rates. A decline in DTI interest rates influences an increase in aggregate demand as it reduces the cost of borrowing and reduces money paid on interest-bearing accounts which will encourage borrowing, spending and investing, while discouraging saving. This will lead to a boost in overall demand for goods and services, which will increase inflation.

- The **exchange rate channel** works through the direct effect of changes in the nominal exchange rate on the prices of imported goods and services.

- As the Bank transitions to a full-fledged inflation targeting regime, emphasis is placed on anchoring **inflation expectations**. The Bank's aim is to shape the public's view of future prices through improved communication strategies and reducing the level of uncertainty in the economy. If the public believes that in the future prices will increase, they will increase the demand for certain goods and services now thus raising the cost for those goods/services thus causing inflation.

The diagram below is a schematic illustration of the main transmission channels of monetary policy decisions in Jamaica.

Source: Bank of Jamaica



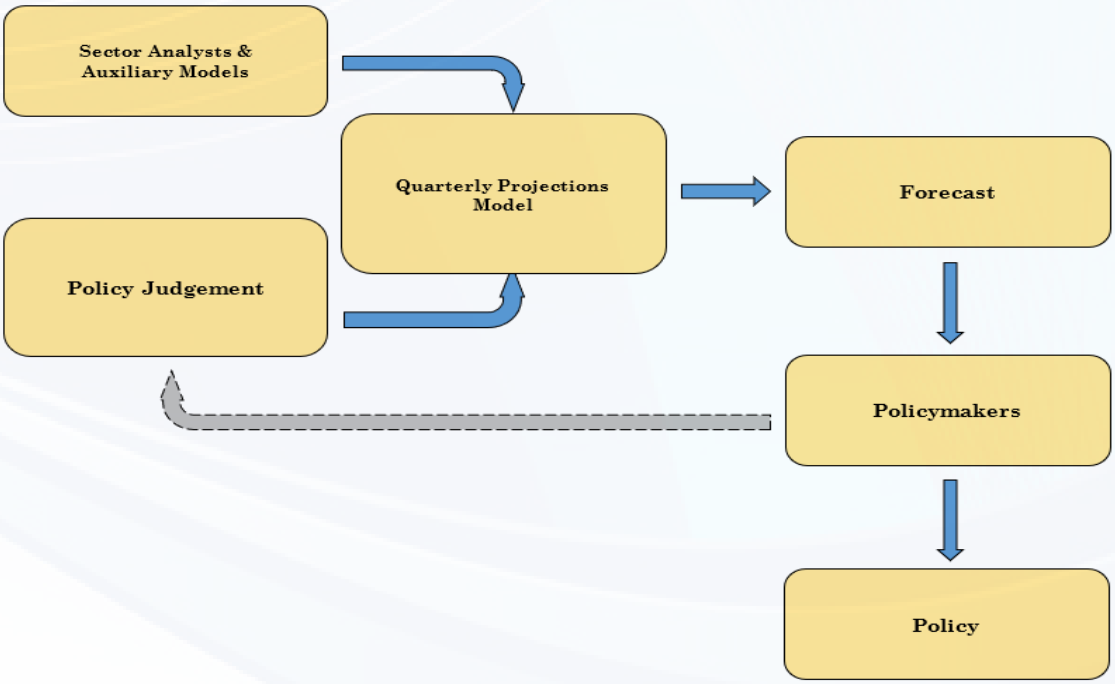
The Bank's view is that the **credit channel** and the exchange rate channels are the main conduits through which monetary policy affects inflation. The credit channel impacts inflation through aggregate demand and the output gap. A change in the policy rate will affect real monetary conditions which is a weighted average of real market interest rates and the real exchange rate. The overall effect on real monetary conditions will influence aggregate demand and hence inflation. The exchange rate channel works through the direct effect of changes in the nominal exchange rate on the prices of imported goods and services.

It takes time before monetary policy decisions have a full effect on the economy. Monetary policy decisions affect inflation with a lag of between 4 to 8 quarters (1 to 2 years). For this reason, monetary policy in Jamaica is forward-looking, and the Bank puts much effort into establishing its view of the economy in the future, and bases its decision on this view. The Bank then makes it a priority to clearly and transparently communicate this view of the future to the Jamaican public. The Bank continues to re-assess the transmission mechanism as the economic environment changes.

Monetary Policy Decision Making

Bank of Jamaica's forecast and policy assessment system (FPAS) is the organized process used by the Bank to develop comprehensive macroeconomic forecasts to support monetary policy decisions geared at the attainment of the inflation target.

An FPAS round is an intensive process that involves the examination of domestic and international trends, model projections, expert judgement and scenario analyses of all the major variables that could impact domestic inflation and aid in identifying the potential path of transmission and risks. This assessment is done eight times during the year using a reduced form forward-looking open economy Quarterly Projection Model (QPM) to inform monetary policy decisions. The Bank's Quarterly Projection Model has been calibrated to capture the transmission mechanism for Jamaica. Forecasts from this model form the basis of the conditional projections and targets for the Bank. The figure below outlines the Bank's forecasting process.



Source: Bank of Jamaica

Prior to the amendments to the BOJ Act, monetary policy decisions were made by the Governor of the Bank. However, Under the Bank of Jamaica (Amendment) Act, 2020 , monetary policy decisions are made by a Monetary Policy Committee (MPC) chaired by the Governor with membership comprising of three (3) ex-officio members and two (2) appointed members (independent non-executive external members).

Policy decisions of the Committee are made by majority vote of the members. In addition to the original vote, the Chairman has the casting vote in cases where the vote is tied.

What Happens When The Inflation Target Is Missed?

If inflation falls either below the lower end of the target (4.0 per cent) or increases above the upper-end of the target (6.0 per cent) then the Bank is required to explain to the Minister of Finance and the Public Service and the Jamaican public why the inflation target was missed, the corrective policy actions that will be taken to restore inflation to the target and any other information the Bank may consider necessary. The Bank is required to notify the Minister of Finance and the Public Service within sixty (60) days of the missed target.

Conclusion

Bank of Jamaica's monetary policy objective is to ensure the maintenance of inflation at low, stable and predictable levels within the Bank's inflation target. Economic relationships are dynamic and so there is a need for continual updates of the knowledge on the monetary transmission mechanism in Jamaica. The unprecedented nature of developments that happen globally will alter, either temporarily or permanently, the behaviour of investors and consumers. The relationships between policy actions and the response of market participants, firms and households are being continually monitored by the Bank to provide an even better guide to policy decisions.

Glossary

Authorized Dealers: These are deposit taking institutions approved by Bank of Jamaica to carry out certain financial transactions.

Cambios: These are operators licensed by Bank of Jamaica to buy and sell foreign exchange.

Cash Reserve Requirement: The requirement by law that a percentage of deposit liabilities of deposit-taking institutions denominated in domestic currency as well as foreign currency must be held as interest free deposits at the Central Bank.

Inflation: This refers to the rate at which the general price level of goods and services in the economy rises over time. In Jamaica, this is derived as the change in the Consumer Price Index (CPI) calculated and published by the Statistical Institute of Jamaica.

Liquidity: This is referred to as the availability of liquid assets or cash in the financial system.

Liquid Asset: An asset either in the form of currency or one that can be easily converted into currency. The liquid assets of commercial banks include notes and coins, short-term deposits at the Bank of Jamaica and any designated Government of Jamaica (GOJ) security.

Monetary Policy Framework: This defines the transmission process for policy actions taken by the Central Bank, and the impact on the final target - inflation.

Monetary Policy Instrument: These instruments, which include open market operations and the reserve requirement ratio, are used by the Central Bank to influence the money supply and credit. These are classified as direct or indirect.

Monetary Policy Transmission: This is the process through which adjustments in the central bank's policy rate induce changes in the prices of goods and services.

Open Market Operations (OMO): Money market trading between the Bank of Jamaica and authorised dealers with the intention of influencing money and credit in the financial system. OMO involves outright sale or purchase of GOJ securities from the stock of securities held by BOJ, and/or repurchase transactions

Price Stability: Changes in the price of goods and services that are so low and predictable, that they hardly affect business plans and decisions.

Nethersole Place
Kingston
Jamaica
Telephone: (876) 922 0750-9
Fax: (876) 922 0854
E-mail: library@boj.org.jm
Internet: www.boj.org.jm
ISBN 976 8044 13 6