Report on Breach of Inflation Target
Bank of Jamaica
15 November 2021

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1. The annual inflation rates at August and September 2021 were 6.1 per cent and 8.2 per cent, respectively, above the upper limit of the target set for Bank of Jamaica (BOJ) by the Minister of Finance and the Public Service ("the Minister"). Under the Bank of Jamaica (Amendment) Act, 2020, the Bank is required to explain to the Minister the reason(s) for this deviation and the remedial policy response, if any, to restore inflation to the target range.

Why was Inflation Higher than the Target?

2. Inflation for the two months was higher than BOJ's target because of (i) the lagged impact of higher international commodity prices, (ii) a recovery in domestic demand and (iii) heightened inflation expectations. There were also significant upward price impetuses from a shock to agricultural prices and an increase in regulated transportation fares.

3. Large increases in international commodity and shipping prices were the principal contributor to the domestic inflation rate rising above the target range. For the twelve months to June 2021, average international grains prices rose by 29.5 per cent. Other commodity prices also rose significantly over the same period (lumber by 131.0 per cent and steel by 82.3 per cent) while international shipping costs rose by approximately 170.0 per cent. The main factors contributing to these increases were a rebound in global demand following declines in 2020 and supply chain frictions due to the COVID-19 pandemic.

4. Relatedly, inflation in Jamaica was supported by a general rise in imported inflation in the context of (a) higher consumer price inflation among Jamaica's main trading partners (particularly the United States of America (US)) and (b) an accelerated pace of movement in the domestic exchange rate since the inception of the COVID-19 pandemic. Inflation in the US rose to 5.4 per cent at September 2021 from 1.4 per cent a year earlier, while the annual average exchange rate (JMD/USD) at September 2021 depreciated by approximately 6.0 per cent relative to the same measure at September 2020. This was higher than the 4.1 per cent depreciation in the same measure at March 2020.

5. Domestic demand in Jamaica improved in 2021, due in part to the relaxation of measures to control the spread of COVID-19. The most recent data published by STATIN indicated that economic activity expanded by 14.2 per cent for the June 2021 quarter and there are indications that the economy also expanded in the September 2021 quarter. In this context, core inflation (the measure that excludes the immediate influence of agriculture and energy prices) increased materially.[1]

6. Since the onset of the COVID-19 pandemic, business expectations of inflation have risen substantially above the Bank's inflation target range. For the Bank's September 2021 survey, expectations of inflation one year into the future was 7.4 percent, approximately 1.3 percentage points above the measure for the March 2020 survey.

7. A shock to agricultural prices and an increase in regulated transportation costs affected inflation significantly in September 2021. Following the passage of two tropical storms in August 2021, the Jamaican consumer price index (CPI) reflected significant increases in the prices of some vegetables. In particular, the *Vegetables* sub-division of the CPI increased in September 2021, relative to the previous month, by 14.5 per cent. Large increases were particularly evident in the prices of tomato, cabbage, sweet pepper and carrot. Finally, the Government's announcement of a 15.0 per cent increase in all fares for Route Taxis, Rural Stage Carriage and Hackney Carriage on 16 August 2021, impacted the inflation rate in September 2021.

What is the Near-Term Path & the Attendant Risks for Inflation to Return to the Target?

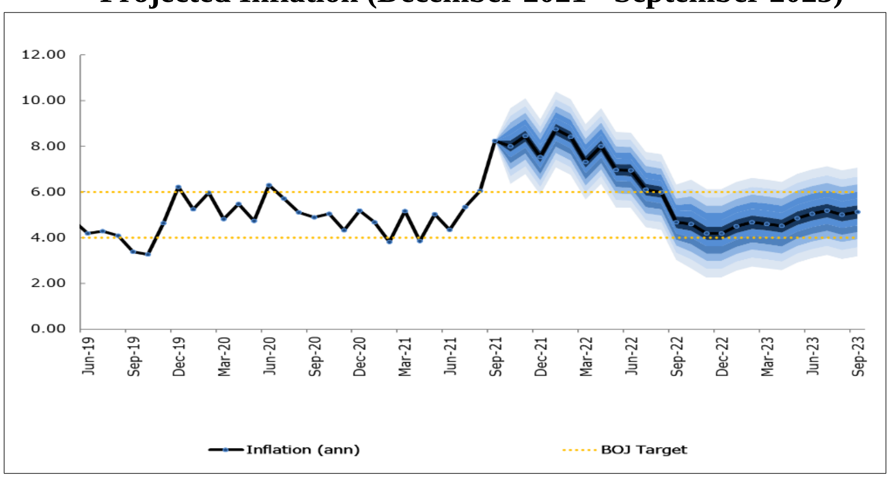
8. BOJ's most recent projections indicate that inflation will average 5.5 to 6.5 per cent over the next 24 months (October 2021 to September 2023), which is higher when compared

[1] Core inflation at September 2021 was 7.8 per cent, compared with 2.3 per cent and 5.1 per cent at December 2020 and September 2020, respectively. The acceleration in core inflation reflected increases in processed food prices, particularly meat, cereal & cereal products as well as oils & fats. The faster rate of increase was also supported by higher prices for school books and stationaries.

to the average inflation rate of 5.0 per cent over the past 24 months. Inflation will continue to breach the upper limit of the Bank's target range over the next 10 to 12 months and is projected to peak in the range 8.0 to 9.0 per cent over this period (see Figure 1).

9. **The two-year inflation forecast anticipates a gradual rise in core inflation, supported by the lagged impact of higher international commodity and shipping prices and a recovery in domestic demand**. The inflation outlook assumes the continued transmission of international commodity and shipping prices, albeit lagged, to domestic processed food, food-related services and energy price inflation. Past increases in agricultural food prices, regulated transportation fares and utility rates will support higher annual inflation for 11 months (October 2021 to August 2022).

Figure 1:
Projected Inflation (December 2021 - September 2023)



10. **Imported energy (crude oil and liquefied natural gas (LNG)) prices are projected to fall over the next two years.** Oil prices are projected to average US$68.60 per barrel for the next eight quarters (December 2021 to September 2023), implying an average quarter-over-quarter decline for the period of 1.7 per cent. Similarly, the price of LNG (as measured by Henry Hub spot prices) are projected to initially remain relatively elevated amid high demand, and then decline in 2022 in the context of higher production. As such, LNG prices are projected to moderate to an average of US$4.00 per million British thermal units (MMBtu) in 2022 from an estimated average of US$4.20/MMBtu in 2021.

11. **The average price of grains is projected to decline over the next eight quarters at an average quarter over quarter rate of 1.4 per cent.** This decline in prices mainly reflects expectations for a rebound in supply, incentivised by earlier high prices.

12. **A projected recovery in domestic demand, which will support core inflation over the forecast period, will be driven mainly by external demand and by still-accommodative monetary conditions**. The Jamaican economy is projected to reflect strong GDP growth in the September 2021 quarter, a momentum that is anticipated to continue over the next two quarters (December 2021 to March 2022). The Bank consequently projects that GDP growth for FY2021/22 will be in the range of 7.0 per cent to 10.0 per cent and will moderate within the range of 3.0 per cent to 5.0 per cent for FY2022/23. The projected recovery in the economy will be led by the travel sector and related sectors such as agriculture and transportation.

13. **There remains some uncertainty around the inflation forecast and the risks are skewed to the upside (which means that inflation could track above the forecast)**. The factors that could cause inflation to be higher than forecasted include continued shocks to domestic agriculture commodity supplies and a higher than anticipated pass-through to domestic inflation of the increases in international commodity prices and shipping costs. There are also upside risks to inflation from higher than forecasted inflation expectations (which could impact price setting behaviour), further increases in regulated prices and higher than anticipated growth in the economy. On the downside, strong recovery in agricultural production could support lower food price inflation in the short-term.

Bank of Jamaica's Policy Actions to Return Inflation to Target

14. To limit the second-round effects of the above noted shocks, which could then cause inflation to breach the upper limit of the Bank's target over a more protracted period, the MPC at its meetings on 28 and 29 September 2021 unanimously decided to reduce the level of monetary policy accommodation by increasing the policy rate to 1.50 per cent from the historic low of 0.5 per cent. The MPC also decided at its meetings on 11 and 12 November 2021 to further increase the policy rate to 2.00 per cent. Accompanying this rate increase, the Committee decided to maintain other measures to contain Jamaican dollar liquidity expansion and reiterated that, while not targeting any specific level of the exchange rate, the Bank will continue to ensure that movements in the exchange rate do not threaten the inflation target.

15. Finally, consistent with meeting its inflation target sustainably in the medium term, the MPC agreed to consider further increases in the Bank's policy rate (and by extension real interest rates, which are currently significantly negative) and maintain or intensify the accompanying measures at subsequent meetings. This position is subject to inflation expectations, other macroeconomic data and, consequently, the inflation outlook evolving as projected.

16. This reduction in the level of monetary accommodation will cause market-based interest rates to rise, which will make the returns on Jamaican dollar assets more attractive relative to foreign currency assets. It will also make saving in Jamaican dollars more attractive and borrowing in Jamaican dollars more expensive. These effects are intended to temper the demand for foreign currency and hence moderate the pace of depreciation in the exchange rate; and, generally, reduce demand in the economy and with it the ability of businesses to pass on price increases to consumers.

17. The MPC will continue to closely monitor the economic environment and is prepared to take further action at the next MPC meeting to achieve its objective.

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