Report on Breach of Inflation Target
Bank of Jamaica
23 February 2022

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1. The annual inflation rates at December 2021 and January 2022 were 7.3 per cent and 9.7 per cent, respectively, above the upper limit of the target set for the Bank of Jamaica ("BOJ/the Bank") 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. In its previous correspondence dated 15 November, Bank of Jamaica indicated that inflation would continue to breach the upper limit of the Bank's target range over a protracted period (10 to 12 months). As published by the Statistical Institute of Jamaica (STATIN), annual inflation at October and November 2021 were 8.5 per cent and 7.8 per cent, respectively, which were broadly in line with the Bank's previous forecast. Inflation for December 2021 and January 2022 continued to track above the Bank's target range but at higher rates than previously projected. The main divisions of the consumer price index (CPI) that contributed to inflation running above target were Housing, Water, Electricity, Gas and Other Fuels, Food and Non-Alcoholic Beverages, Transport and Restaurants and Accommodation.

3. Inflation continued to breach the upper limit of BOJ's target range because of (i) the impact of higher international commodity prices, (ii) improvements in domestic demand, and (iii) heightened inflation expectations.

4. Large increases in international commodity and shipping prices were the principal contributor to the domestic inflation rate remaining above the target range. For the twelve months to December 2021, average crude oil and grains prices rose by 72.4 per cent and 37.3 per cent, respectively. The price of liquefied natural gas (LNG) also rose by 74.4 per cent over the same period, while international shipping costs rose by 249.9 per cent. The main factors contributing to the increase in crude oil prices were the continued recovery in global oil demand and investor expectations that demand will exceed supply in 2022.

5. **Relatedly, inflation in Jamaica was supported by higher consumer price inflation among Jamaica's main trading partners (particularly the United States of America (US)).** Inflation in the US accelerated to 7.5 per cent at January 2022 from 1.4 per cent a year earlier. However, the annual average exchange rate (JMD/USD) at December 2021 depreciated by 5.9 per cent, relative to the same measure in 2020. This represents a slower pace of depreciation when compared to the 6.6 per cent depreciation recorded at December 2020.

6. **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 5.8 per cent for the September 2021 quarter. Furthermore, there are indications that the economy expanded at a faster pace (in the range of 5.0 per cent to 7.0 per cent) in the December 2021 quarter.

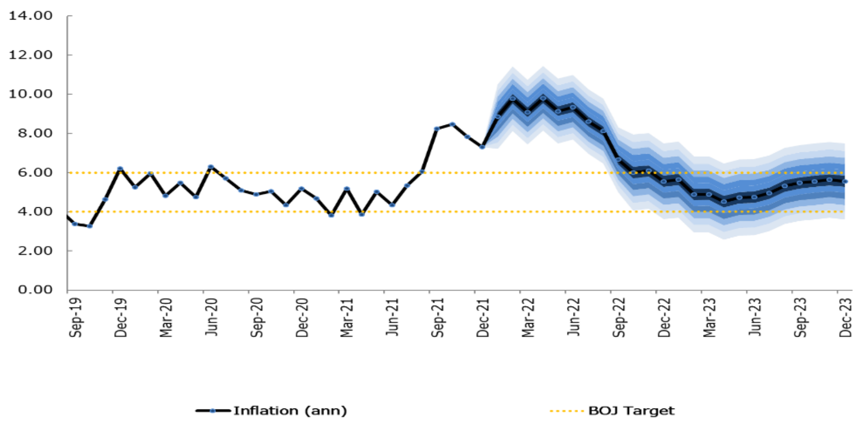
7. **Business expectations of inflation remain elevated and have increased further.** In the latest survey of business expectations of inflation in December 2021, respondents indicated that they expect inflation over the ensuing twelve months to be 9.8 per cent, significantly above the Bank's inflation target and the previous survey of 8.9 per cent. This increase in expectations contrasts with the Bank's objective of returning inflation to the target range by the second half of 2022. Indicative yields on Government of Jamaica (GOJ) long-term domestic currency bonds also increased during the December 2021 quarter in the context of an upward shift in expectations.

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

8. **BOJ's most recent projections indicate that, without further policy action, inflation will average 6.0 to 7.0 per cent over the next 24 months (February 2022 to December 2023), which is higher when compared to the average inflation rate of 5.7 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 of 9.0 to 11.0 per cent over this period (see

Figure 1). Conditional on the Bank's monetary policy posture, inflation is projected to return to the target range in the December 2022 quarter.

Figure 1:
Projected Inflation (March 2022 - December 2023)



9. The two-year inflation forecast anticipates the continued lagged impact of higher international commodity and shipping prices, continued recovery in domestic demand and seasonal agricultural price pressures, the influence of which will be partly offset by some moderation in inflation expectations. The recovery in domestic demand is forecasted to be driven mainly by external 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 regulated transportation fares and utility rates will support higher annual inflation for a further 8 months (February 2022 to August 2022).

10. Imported energy (crude oil and LNG) prices are projected to fall over the next two years. Oil prices are projected to average US$74.50 per barrel for the next eight quarters (March 2022 to December 2023), implying an average quarter-over-quarter decline for the period of 1.5 per cent. Similarly, the price of LNG (as measured by Henry Hub spot prices) is projected to initially remain elevated amid high levels of demand relative to supply and geopolitical tensions in 2022 but to moderate to an average of US$3.63 per million British thermal units (MMBtu) in 2023 from a projected average of US$3.79/MMBtu in 2022.

11. The average price of grains is projected to increase over the next eight quarters at an average rate (quarter over quarter) of 0.14 per cent. This increase in prices, particularly for the first half of 2022, is expected to reflect increased demand and higher input costs. However, prices are projected to decline thereafter, reflecting the impact of increases in supply and the slowing pace of global economic activity, notably in China.

12. The continued recovery in domestic demand will support core inflation over the forecast period. This recovery is projected to be primarily driven by external demand. The Bank projects that GDP growth for FY2021/22 will be in the range of 7.0 to 10.0 per cent and is forecasted to moderate within the range of 2.0 to 4.0 per cent for FY2022/23. The projected recovery in the economy will be led by the services industry (particularly tourism), notwithstanding setbacks from the Omicron variant of the coronavirus. The GDP forecast also assumes that the temporary disruption to production at one of Jamaica's alumina plants will be resolved by June 2022.

13. There remains some uncertainty around the inflation forecast. However, the risks are assessed to be balanced (which means that actual inflation should track in line with the forecast). The factors that could cause inflation to be higher than forecasted include a higher than anticipated pass-through from imported inflation to domestic inflation and heightened inflation expectations. The prospects of earlier and stronger monetary tightening among Jamaica’s major trading partners may also precipitate capital outflows and pressures on the exchange rate, if domestic monetary policy is not appropriately aligned. Further, underlying demand pressures may begin to threaten the stability of the foreign exchange market and, with it, diminish the prospects of inflation returning to the target range. On the downside, weaker global growth from the possibility of geopolitical tensions as well as stronger than expected and more persistent supply constraints could impact domestic economic activity and consequently demand.

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

14. To continue limiting 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 16 and 17 February 2022, unanimously decided to reduce the level of monetary policy accommodation by increasing the policy rate to 4.00 per cent from 2.50 per cent. The Committee also decided to pursue more substantial measures to contain Jamaican dollar liquidity expansion and maintain stability in the foreign exchange market. Finally, consistent with meeting its inflation target sustainably in the medium term, the MPC agreed to consider maintaining or expanding its suite of measures at subsequent policy meetings. This position is subject to inflation, inflation expectations and other macroeconomic data evolving as projected.

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

Bank of Jamaica