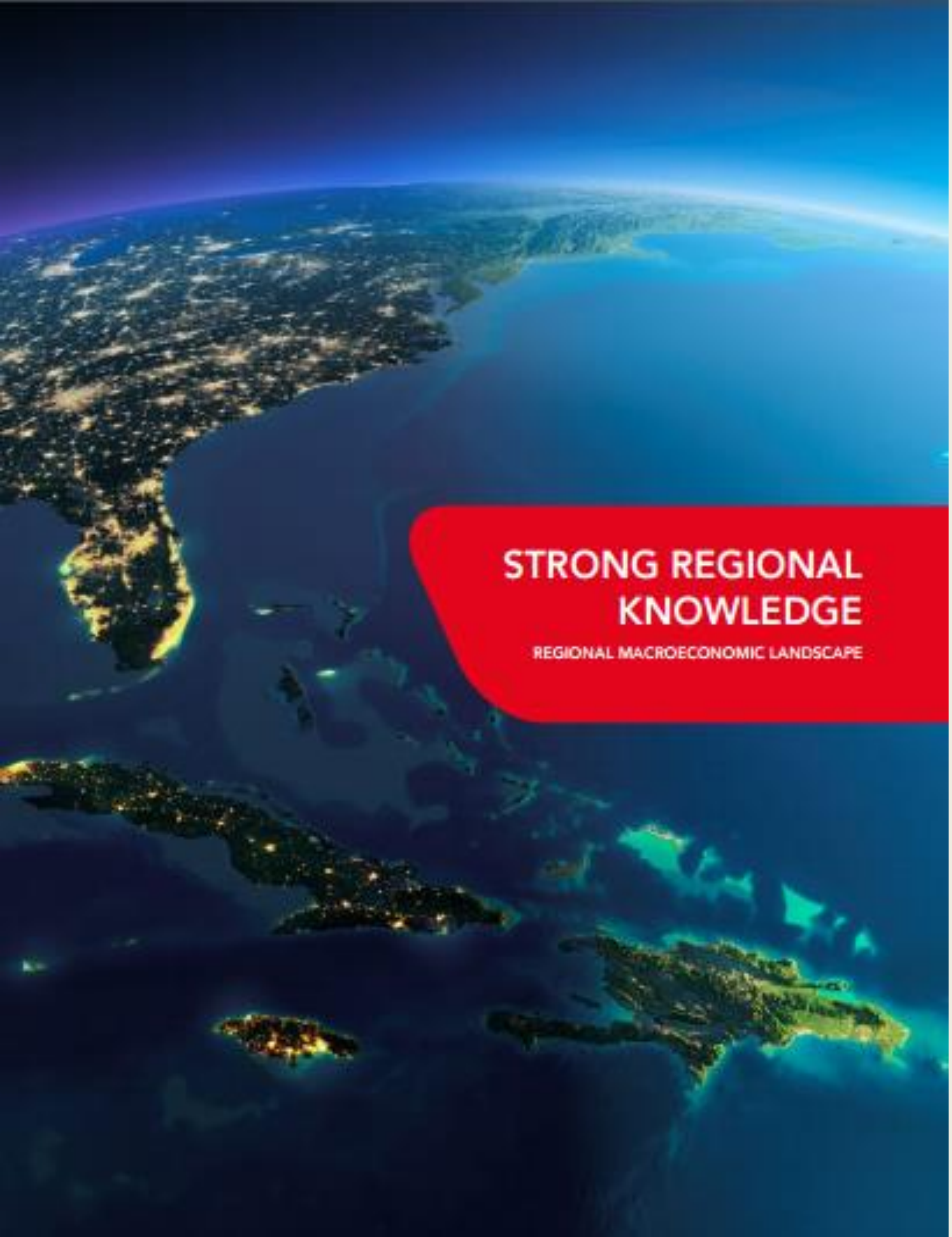

Why the Exchange Rate is no longer the important indicator and why we should monitor Inflation Instead.

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Your best interest at heart.

How Did the Exchange Rate Become So Important

- Historically the exchange rate has been relatively well behaved. From 1971 to 1978 the exchange rate was less than J$1 to US$1. Meaning that it took more than US$1 to purchase a J$1.

- The economy did suffer the impact of global oil price shocks as well as structural adjustment under the IMF. However, this manifested itself in one off exchange rate movements before a return to relative stability.

- We again saw some devaluation between 1978 and 1984; however we saw sharp movements followed by stability. Between 1985 and 1989 we had a fixed exchange rate regime of about J$5.50 to US$1.

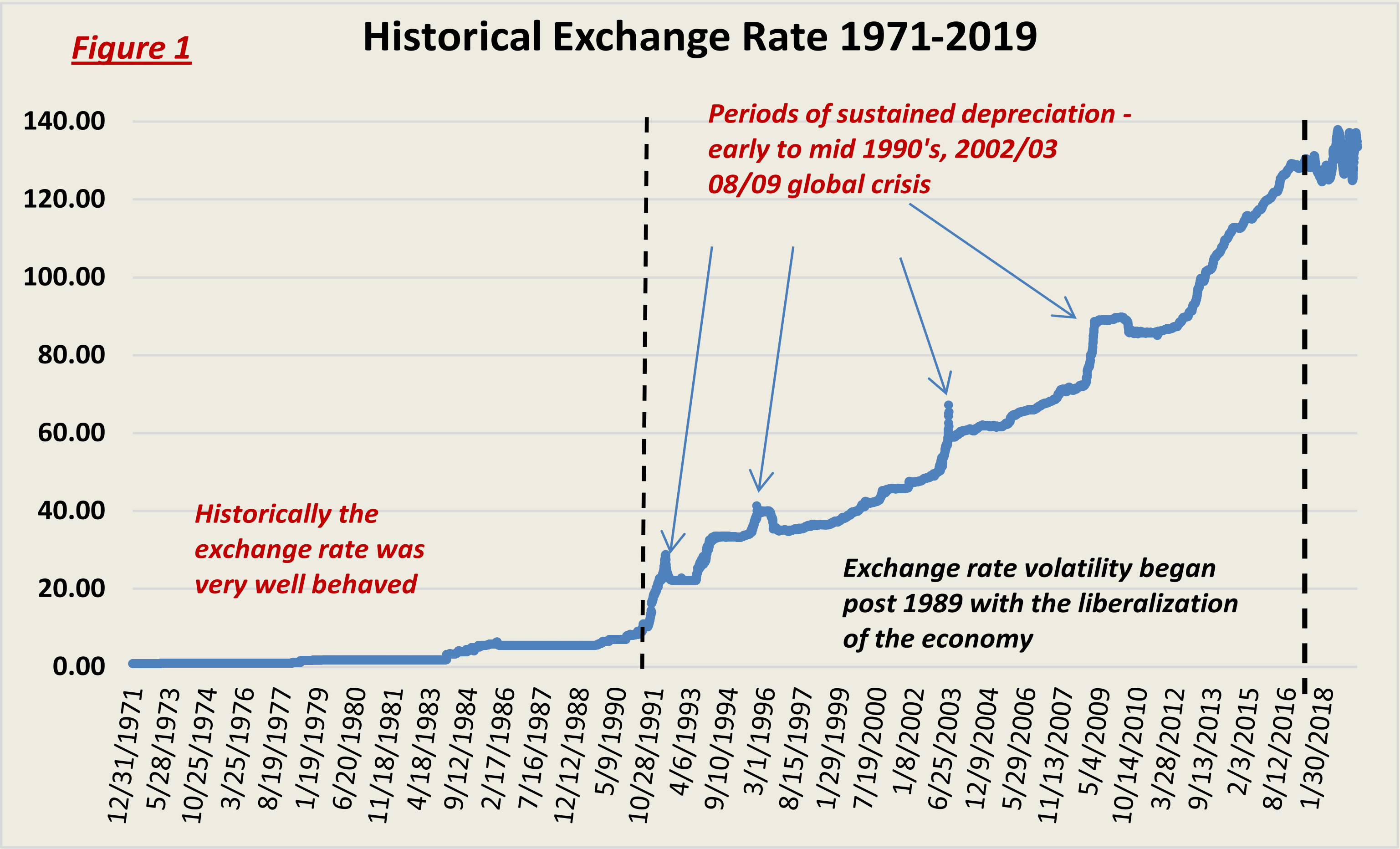
How Did the Exchange Rate Become So Important

- Sustained volatility began post 1989 with the liberalization of the Jamaican economy and a shift in global economic policy. Free trade, globalization and an aggressive export oriented economy became the dominant global economic paradigm.

- We also abandoned the fixed exchange rate regime (underpinned by Exchange Control Act & an auction based approach to determine access to FX). Jamaica adopted an IMF recommended market based approach. Here the exchange rate would be determined by market forces only, i.e. demand and supply and there would be free movement of FX in and out of the country.

- It is argued that these adjustments were made without the BOJ having the necessary ammunition in terms of Net International Reserves and possible regulatory teeth to respond to any potential shocks.

How Did the Exchange Rate Become So Important



How Did the Exchange Rate Become So Important

- Liberalization also meant that local manufacturers who had protection via both tariffs (taxes in imports/ higher import prices) and quotas (restrictions on the volume of goods to be imported) were suddenly thrust into a highly competitive market of low priced imports and higher volumes. This meant lower profits.

- Some companies, especially on the export oriented side (Garmex / Freezones) sought to set up business where labour laws were less stringent and wages were cheaper.

- Both of these factors combined to lead to movement of companies from Jamaica to more attractive destinations. This further meant reduced economic activity and job losses.

- What is also **very important** here, from an exchange rate perspective, is that exports would be declining and imports would be increasing, i.e. reduced earning of USD and increased local demand for USD to pay for imports.

How Did the Exchange Rate Become So Important

- The adjustment to the exchange rate regime from a fixed rate regime to one determined by market forces without the necessary Net International Reserves also led to rapid devaluation. In response to the devaluation, the monetary policy authorities responded with higher interest rates to stem the outflow of US-dollars.

- Higher interest rates combined with poor business practices further led to the local financial market crisis and consequently FINSAC.

- For the average Jamaican, the simplest variable to identify, the one for which information is most readily identified and understood as the causing factor, was and remains the exchange rate.*

The New Economic Paradigm Post-1989

- ✓ This paradigm shift led to a period (about 3 decades) of economic volatility characterized by:-
  - (I) high debt/GDP ratio
  - (II) persistently high fiscal deficits
  - (III) weak GDP growth
  - (IV) persistently high and rising current account deficits
  - (VII) high inflation
  - (VIII) Currency volatility

What Determines Exchange Rate Depreciation

- The current account, which measures the transactions between a country and the rest of the world in terms of goods & services, the income account and current transfers, gives a directional view of the exchange rate.

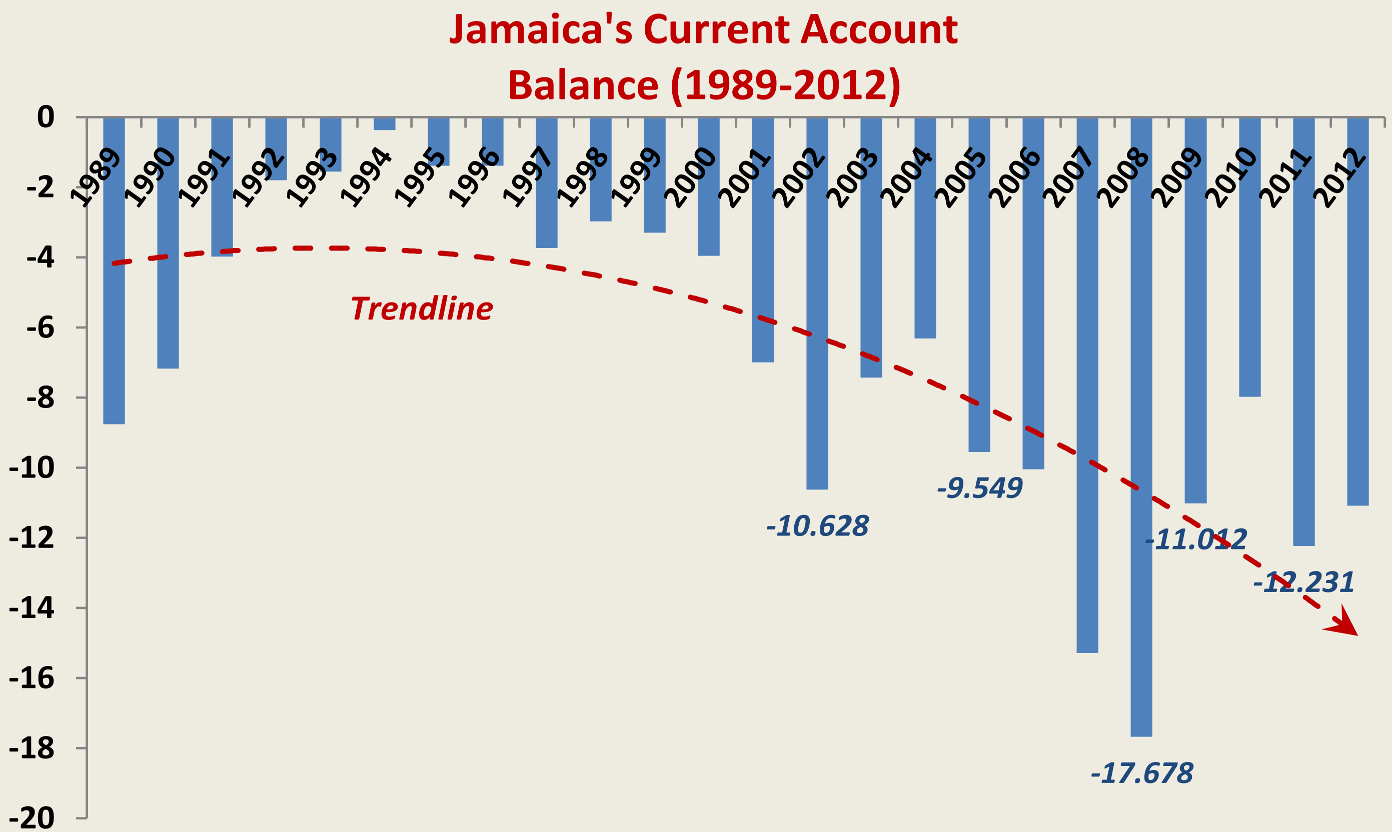
  * An important part of the current account is the balance of trade which measures goods and services imports minus goods and services exports.

- A current account surplus suggests that a country is a net lender to the rest of the world, while a negative current account balance indicates that it is a net borrower.

- Jamaica has, since 1989, run a persistent, and often rising current account deficit, i.e. we have become a larger and larger net borrower of foreign exchange from the rest of the world.

What Determines Exchange Rate Depreciation

- The average current account deficit between 1989 and 2012 was 6.9%. This is an indication that the country's exchange rate should be depreciating relative to its major trading partner, the USD.



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The Shift in The Economic Paradigm

- Given the shift in the economic paradigm and more importantly, the weak economic variables, the players in the domestic economy began to act accordingly.

- The Jamaican dollar and J$-denominated assets were not seen as an attractive option for the storage of long term wealth if interest rates were not sufficiently high to compensate for the risk.

- If there was any adverse change in the underlined fundamentals the market's response was a shift/devaluation of the exchange rate.
  - If the fiscal deficit came out wider than budgeted, if the debt levels came in higher than expected, If inflation came in higher than expected, or if there was a weather related shock or any shock to the global economy whether endogenous or exogenous……there would be currency depreciation to compensate for the perceived increased risk. *

The Exchange Rate Barometer

- The exchange rate therefore became a barometer/ measure of the severity of the shock or the markets perception of the severity of the shock facing the economy.

- Also importantly it allowed the economy to absorb a shock for a time and depending on the severity of the shock or the prolonged nature of the shock…the monetary authorities would respond later usually:-

  (I) selling USD directly to the market, (II) higher interest rates if the situation/devaluation was prolonged, (III) moral suasion and/or the issuance of short term instruments to mop up/absorb excess J-dollar liquidity chasing USD.

Basic Market Stability Equation

- Basic Market Equation that maintained a rough level of stability within the financial markets locally.

J$ Interest Rate = USD Devaluation + USD interest Rate

Rate on the J$ Instrument	=	Projected 12-month Devaluation	+	Interest rate on a similar tenor US-dollar Instrument

- Therefore, the exchange rate, its pass through effect to rest of the domestic economy via changes in prices (import content of the food basket/inflation basket) and the fact that USD was needed for purchasing oil (despite Petrocaribe)……this ensured that J$/US$ devaluation was of paramount importance.

Another Paradigm Shift

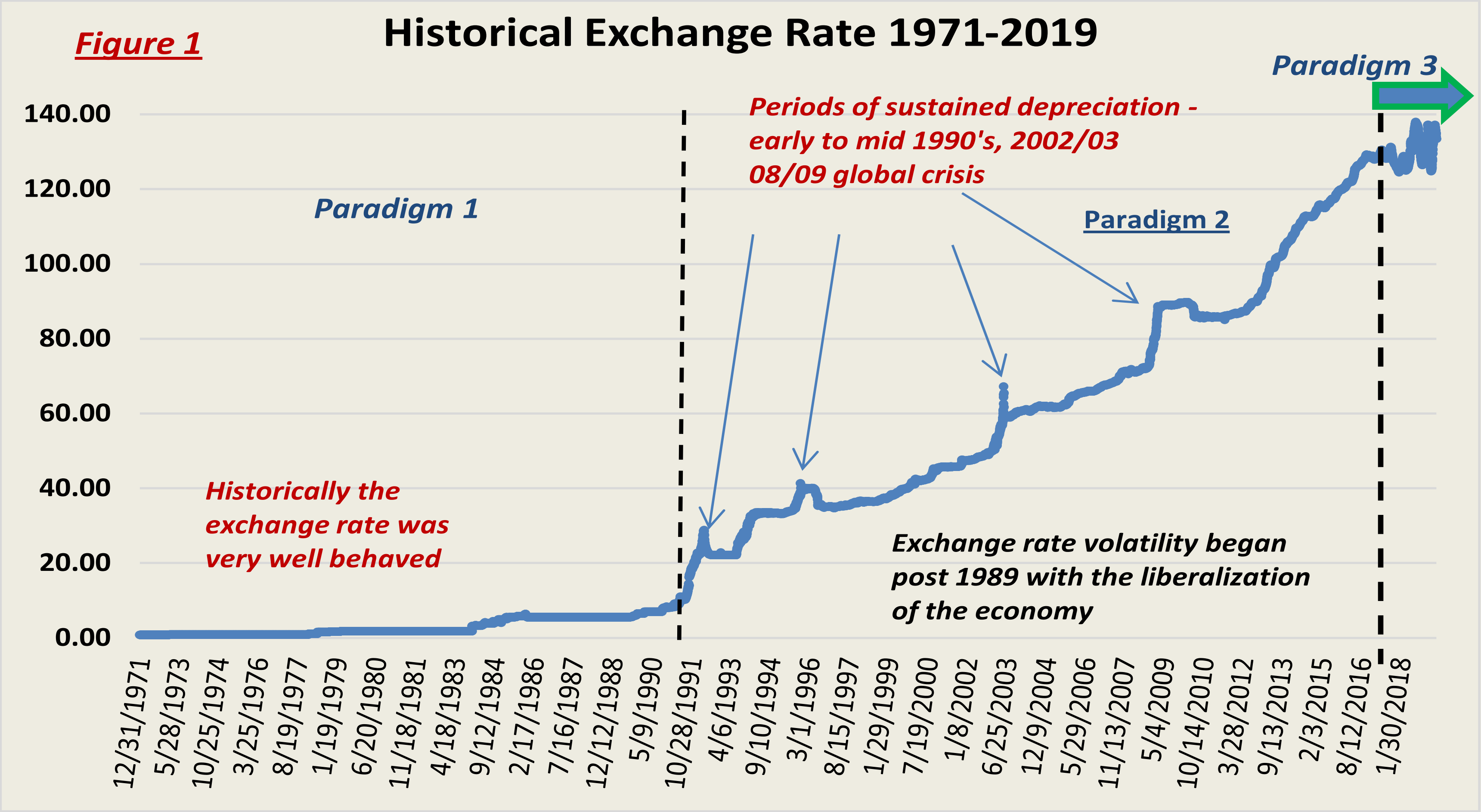
- The fiscal situation became unsustainable. As the dollar devalued the nominal debt rose, as fiscal deficits were consistently run, the debt rose.

- The Jamaica Debt Exchange (JDX), National Debt Exchange (NDX) and the consequent IMF program has led to a period of fiscal prudence. Fiscal prudence has led to lower deficits, reduced debt and has created space in the fiscal numbers for the government to spend; especially on the capital budget side.

	Jamaica Selected Economic Indicators								
	2010	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018 Est.**
GDP %-age Change	-1.44	1.42	-0.50	0.21	0.57	0.85	1.50	0.66	1.38
Inflation, eop (%-age Change)	11.74	6.01	8.00	9.47	6.36	3.66	1.73	5.25	2.41
Unempl. Rate (%-age of Labour Force)	12.38	13.00	13.93	15.28	14.20	13.50	12.84	12.20	11.60
Gross debt/GDP	141.86	140.46	145.05	138.71	137.86	121.31	113.64	101.12	99.38
C/A %-age of GDP	-7.97	-12.23	-11.09	-9.17	-7.45	-3.13	-1.37	-2.59	-2.81
Fiscal Deficit (%-age of GDP)	-10.9	-6.1	-6.2	-4.1	0.1	-0.5	-0.2	0.50	0.30
Net International Reserves (NIR) US$-millions	2,171.41	1,966.11	1,125.58	1,047.83	1,996.65	2,597.57	2,987.52	3,201.80	3,005.41
6-Month Treasury Bill Rate (Interest Rate)-Avg Yield	7.48	6.46	7.18	8.25	7.14	6.04	6.56	4.63	2.07

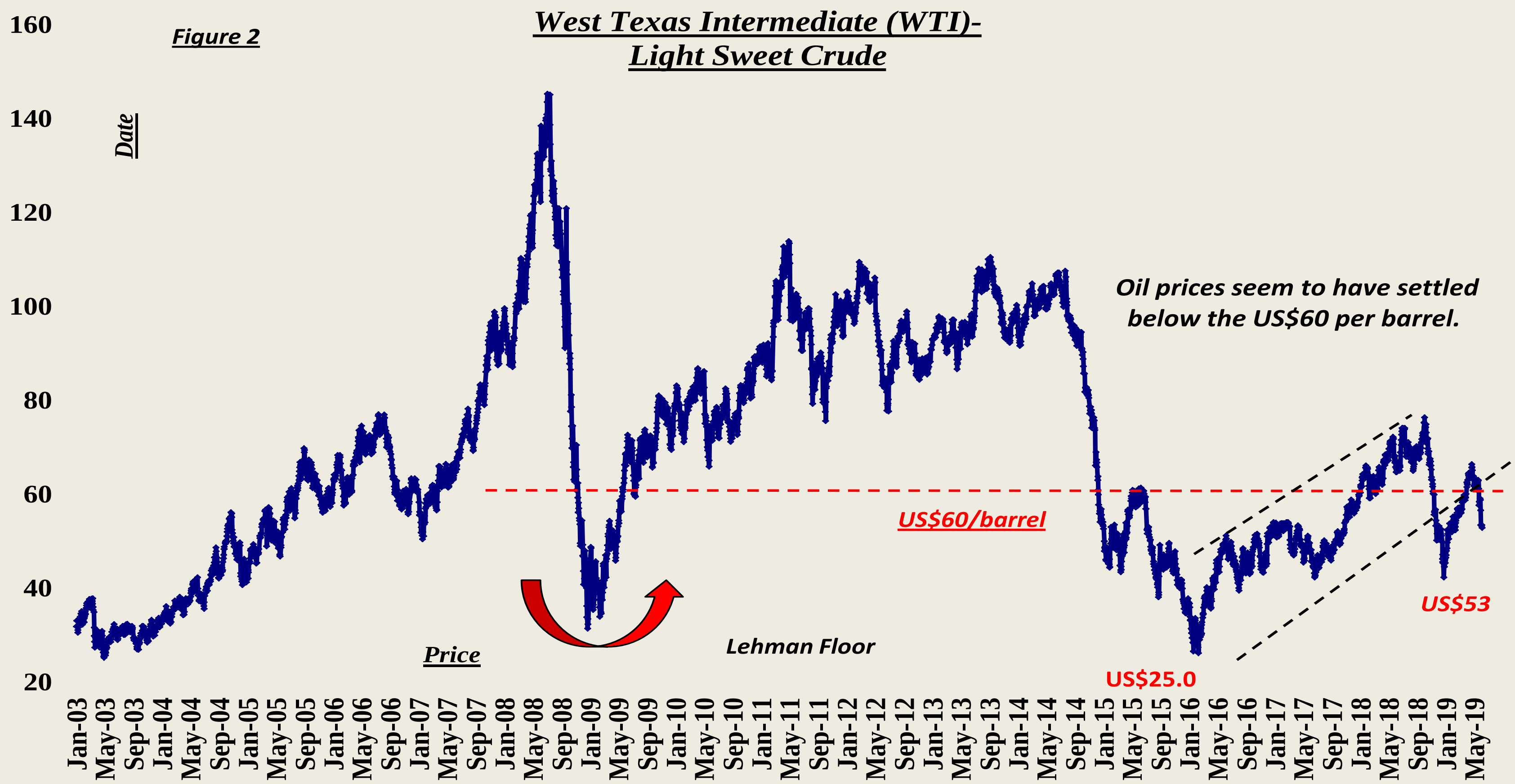
Source: WEO Database-IMF as @April-2019, Bank of Jamaica (BOJ), JMMBIR

Another Paradigm Shift



Oil Price Reduction

The factors driving the underlined currency volatility have been eroded to a large extent by fiscal prudence as well as the reduction in global oil prices.



The Pass Through Effect

- Technical/econometric work estimating how strong the pass through effect from depreciation to inflation is in Jamaica, is somewhat conflicting. Some work done suggests that the pass through effect is about 40% while other research suggests that it is much lower.

- From our perspective we believe that the pass through effect has declined. As noted before fiscal prudence and its impact on other economic variables has helped as well as the reduction in global oil prices.

- One important variable that has helped to reduce the importance of currency volatility to the overall inflation is interest rates.

- Lower interest rates have reduced the cost of capital. While it is argued that the reduced cost of capital is not filtering through enough to SME's, some companies and individuals have experienced the reduced rates.

Interest Rates

- Reduced domestic rates now indicate that domestic production is now becoming more important to the overall inflation basket.

- Lower funding to the property market has led to a housing boom, especially in the corporate area. Movements in the price of housing affects the inflation basket more than it did previously.

- Domestic companies are now seeking to replace imported content with domestically produced raw material. Hence domestic raw material price movements (part of the inflation basket) are growing in importance.

- We must also realize that while the metropolitan region has a large percentage of the population, it is not the entire island. Locally produced goods and services from rural areas contribute to the inflation basket. The exchange rate plays a less critical role in these parts of the island, remittances aside.

A Change in the Financial Market Landscape

- Financial institutions, especially brokerage houses have adjusted the way that they do business.

- GOJ global bonds, exchange rate movements, domestic government debt generally…plays a less of a critical / significant role in the way that we operate going forward.

- Net Interest Income from securities is projected to be less important to profitability. This is to be replaced by income from capital market deals, loans (structured, syndicated), a portfolio approach for clients, regional expansion (Latin America & the Caribbean), bundled products and generally a more diversified income stream.

- As portfolio managers our focus is shifting from depreciation and currency volatility to inflation generally as a measure above which portfolios should perform. *

FIXED EXCHANGE RATE

- A fixed exchange rate suggests to the market that the government is able to provide all the FX needed at a set/fixed price.
- This suggests that reserves should exist to meet all needs, including investment portfolio needs. This opens the exchange rate to being constantly “tested” by the market.
- Traditionally fixed exchange rates come with restrictions on access. In Barbados & Trinidad, real sector needs take priority. This suggests restrictions on access for financial sector companies….which may cause some uproar.

FIXED EXCHANGE RATE

- There is also a cost to the government of defending the exchange rate. i.e. We spend USD to maintain the exchange rate at a cost.

- Further, if the NIR is depleted it has to be funded through borrowing. Hence the government has to capitalize the BOJ to prepare it for defending the currency.

- Rough estimates suggest that the cost is about J$25 billion for each fiscal year.

FIXED EXCHANGE RATE

- A flexible exchange rate allows the economy to absorb shocks. As with all types of market responses, devaluation may be an overreaction…in which case there might be a quick reversal.

- A fixed rate means that for every shock interest rates often becomes an overused tool of monetary policy. This would send conflicting / inconsistent views to the market.

- This may suggest a lack of policy consistency which can erode confidence.

TIME CONSTRAINT