***SOVEREIGN*: Jamaica**

Is there room for further reduction in domestic interest rates?

In June the Bank of Bank of Jamaica (BOJ) reduced the policy rate by 50 basis points (bps) or 0.5% to 2%. This marks the second time in 6 months that the central bank has lowered the signal rate. The central bank has indicated that, in its opinion, lending rates are too high, despite downward movements over the last 3 years. While demand and supply conditions to a large extent influence loan rates, there are other factors that feature prominently in the mix. Three such factors are: 1) expected inflation 2) credit risk and 3) liquidity premium. The latter two factors we will refer to collectively as risks. As such, for interest rates to fall and remain subdued over the long-run two conditions must be satisfied in that inflation and the overall risk to the economy has to decline over time.

Interest Rate and Inflation, the Connection

Creditors expect that at a minimum the purchasing power of funds loaned will remain the same at the end of the terminal life of the loan agreement where the principal is expected to be repaid in full. Therefore, to maintain the purchasing power between a sum loaned today and the sum that is repaid, say a year from now, the lender will at least charge an interest rate equivalent to expected inflation. If inflation is low and fairly predictable then all things being equal one can expect relatively low interest rates. However, in an environment where inflation is volatile interest rates are usually high, even in periods where inflation is on a downward path. As such, for interest rates to stay on a low and sustained path, a central criteria is that inflation must be predictable and low. Thus, a subdued policy rate while a necessary criteria is not sufficient in and of itself to dictate low lending rates in an environment where expected inflation is relatively high.

Assessment

We have gathered inflation and interest rate data over a 69 month period spanning September 2012 to May 2018. In order not to over complicate our analysis, we assume that risk, including liquidity premium, remains fixed throughout the period. In addition we have used the least square line for actual inflation as a proxy for expected inflation. The difference between the weighted average interest rate and the least square line at the start and at the end of the period were relatively unchanged at around 9%. Our assessment is that the directional shift in interest rates mirrors the expected inflation path over the period. Thus, what is needed for lower interest rate is 1) sustainably low inflation and 2) structural changes in the economy that will enable better credit quality at the macro level thereby helping to reduce the overall risk premium.

While it is envisaged that inflation will remain relatively subdued compared to historical levels, we are not of the opinion that it will stay below 3%-4% for very long. This view reflects the nature of the Jamaican economy,

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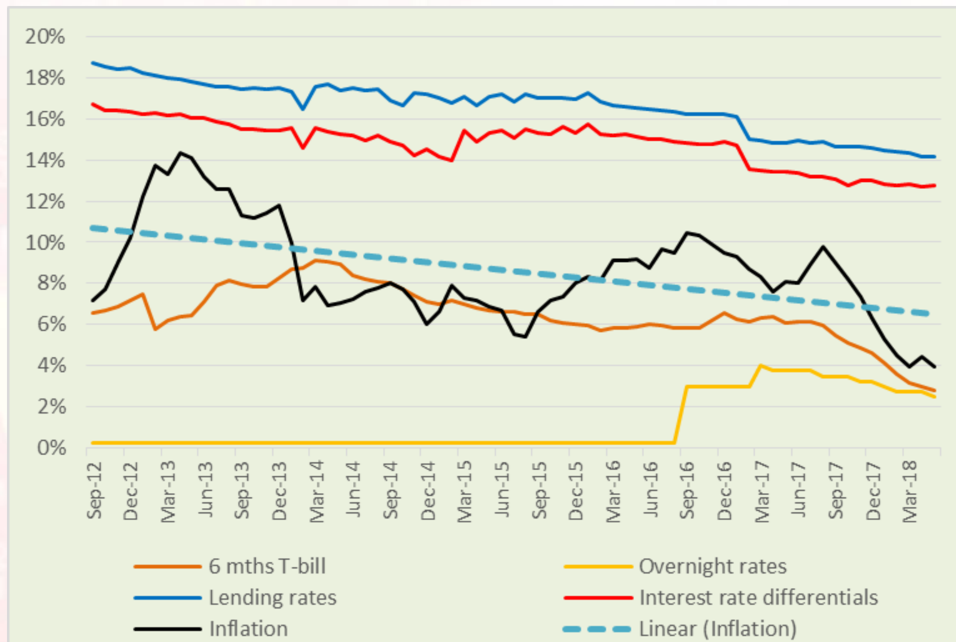
its dependency on the international economy and the prominence of local agricultural produce in the inflation basket. As such, increases in external prices are transmitted directly to the basket or indirectly via depreciation of the domestic currency. While significant structural adjustments have been made to improve the external liquidity position, Jamaica remains susceptible to external shocks that can easily wipe out the gains that have been made leading to volatility in the currency market.

The sovereign imports a large quantum of consumables and raw materials, therefore volatility in the currency market is transmitted to local prices. Domestic agricultural prices, which constitute a significant proportion of the consumer basket, are to a great degree influenced by weather conditions. The agriculture sector is not resilient to changing weather patterns and as such bad weather tends to result in low production levels causing higher domestic prices. Given the combination of factors outlined above, we are expecting inflation to run above 5% over the medium-term with the risk tilted towards the upside. In a Fiscal Policy Paper tabled in Parliament in February 2018, the government is programming inflation of 5% over the similar period. The BOJ has indicated a gradual shift from exchange rate towards inflation rate targeting and has set a notional inflation target of 2% - 9% for FY 2018/19, which is very wide band.

Overall risk reduction in the economy

Figure 1: Weighted average lending rates, overnight lending rate, 6-mth T-bill yields and inflation



Sources: BOJ and JMMBIR

Improvement in credit quality will evolve with overall developments in the economy. This will not happen overnight and it will take time for the economy to grow at a higher rate on a sustainable basis resulting in improvements in the job market and company balance sheets. As individuals and corporates are constituents in the economy, their credit quality largely reflects a systemic shift in economic conditions. While there are some individuals and corporates that have low risk profiles and are assigned low credit premium, this is not true for the vast majority of operatives in the economy.

Yes, GOJ credit quality has improved over the last 5 years and is reflective in a positive change in credit ratings for the sovereign and lower borrowing rates. Although the GOJ is still beset with certain structural challenges, these are somewhat negated by the government's ability to impose taxes and print money, hence the significant shift downward in sovereign's domestic bond risk premium. Individuals and corporates do not have the luxury

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of doing the same. One method of computing corporate credit is to add a risk premium on what is deemed to be the risk free rate - GOJ's domestic/external bond rate. This premium is largely dependent on the credit quality/balance sheet of the borrower. It goes without saying that corporates with high quality balance sheets are able to borrow at very low rates. In fact, due to relatively low interest rates a number of corporates have opted to refinance loans either through direct credit lines from financial institutions or through the issuance of corporate papers. Many individuals, likewise, have also taken the refinancing route.

Opinion

The domestic economy has slowly evolved where the medium-term growth prospects have improved, business and consumer confidence are elevated and overall risks to the economy are lower than they were 5 years prior. Annualized growth however is lower than envisaged by the authorities due in part to slower than planned private investments and domestic consumption. Both of these variables are to some extent dependent on interest rates. All things being equal, lower interest rates induced high levels of investments and demand for loanable funds for consumption purposes.

Interest rates have fallen over the past 5 years, in line with the shift in the inflation path. The authority however is of the view that interest rates are still too high and have reduced the policy rate to help achieve this goal. We however are of the opinion that while this is necessary, it is not sufficient to achieve lower interest rates as expected inflation and credit quality/risk premium play very important roles in determining interest rates in the market. Accordingly, to the extent that inflation expectations remain relatively high and credit quality is improving at a very slow pace, lending rates are likely to adjust downward much slower than the authorities desire. A catalyst to improved credit quality, all things being equal, is a higher growth rate. This tends to foster higher household income/wealth and improvements in corporate balance sheets. We are not anticipating any monumental shift in economic growth in the near term, therefore movements in interest rates are much more likely to be influenced by shifts in expected inflation than adjustments to the overall risk premium. The question therefore is can Jamaica maintain an inflation rate below 3%. If this is possible, then there is further room for downward adjustments in domestic lending rates. However, history and the structure of the domestic economy do not favour this path.

The other risk to the interest rate trajectory is the spread differential between Jamaican and international rates. US Federal Reserve rates, the global benchmark for risk, is on an upward path. Consequently, Emerging Market interest rates, both domestic and the rate/yield on global debt, is projected to adjust upwards. While Jamaica's risk profile has improved, as noted earlier, it has not improved by that gargantuan level. If local policy rates are kept low then some other variable will come under pressure to maintain the risk differential between the sovereign and the global benchmark.

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APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT—As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation **DEFINITIONS/RECOMMENDATIONS**.

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