***SOVEREIGN*: Jamaica**

Foreign Exchange Volatility: How long will it last?

During the second half of 2017 high levels of domestic economic confidence coupled with elevated USD liquidity resulted in the Jamaica dollar (JMD) gaining strength against the US dollar (USD). As at May 2017 the 12-month depreciation rate for the JMD relative to the USD was 5.1%. However by year-end the JMD recovered and appreciated by 2.7% driven in part from increased USD flows. As at April 2018, the value of the JMD was relatively in line with the value as at end-December 2017. However, the local currency fluctuated over the period in line with expectations.

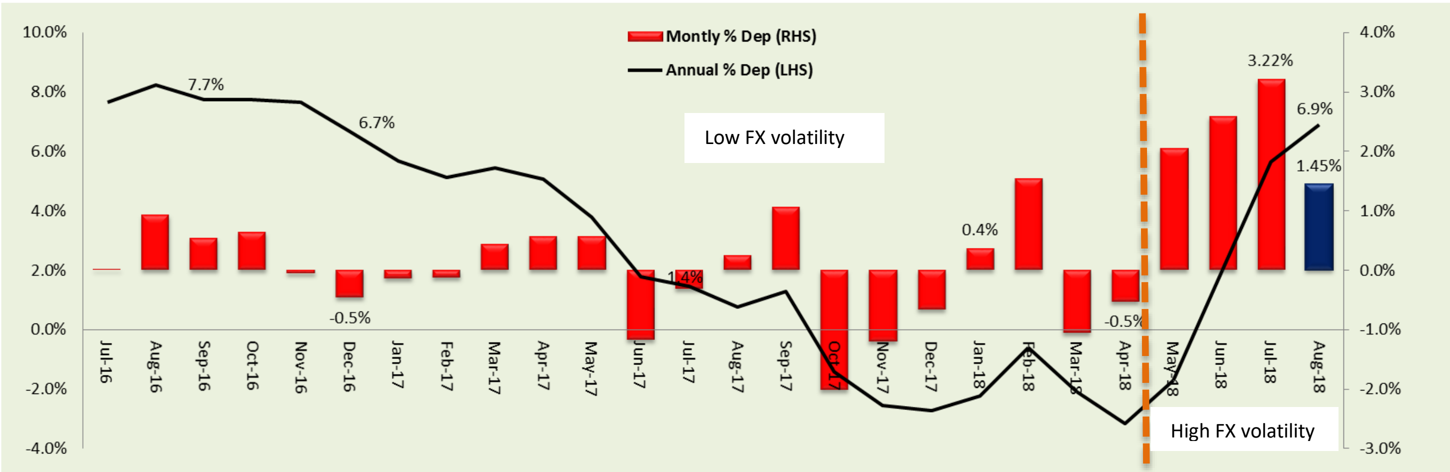
The four-month period, May- August, has ushered in a one way movement in the value of the JMD, as the local currency lost 9% cumulatively. Notably, for the similar period in 2017 the value of the JMD was relatively static. What has brought about this marked shift in developments in the foreign currency market? Several events, some of which are inter-related, have a profound effect on the market, and include the following:

I. The debt transaction involving the National Water Commission (NWC) and the National Commercial Bank (NCB);
II. High Jamaica dollar liquidity, low domestic interest rates and rising US interest rates;
III. Purchase of USD to invest in foreign currency denominated asset; and
IV. Purchase of foreign currency to exchange to pay down USD debt.

In mid-May NCB announced a deal whereby it acquired a bond from NWC amounting to J$15 billion. Proceeds from the bond was to be used by NWC to retire USD debt that is guaranteed by the Government of Jamaica. To make good on the USD payment on behalf of the NWC, NCB was active on the buy-side of the foreign exchange market in June. Due to the high volume of USD being purchased by the Bank and end-users in an environment where USD liquidity was relatively weak, the pace of depreciation of the Jamaica dollar picked up momentum.

The NCB transaction served as a catalyst to push rates higher owing to pent up demand for USD in the foreign exchange market due to the high levels of JMD liquidity and contracting differentials between domestic and external interest rates. Demand for the USD increased from June through to August, pushing the exchange rate to new highs throughout the period, as USD liquidity dried up. The demand emanated from three main sources: (i) end-users, (ii) portfolio managers and (iii) speculators. Additionally, resulting from the low domestic interest rate environment and growing foreign exchange risks, persons/institutions with US-dollar debt opted to use the opportunity to borrow JMD to pay-down their USD obligations. This too resulted in additional demand for USD and put further pressure on the exchange rate.

Figure 1: Rate of change of the JMD relative to the USD: Annual and Monthly



Sources: JMMBIR and Bank of Jamaica

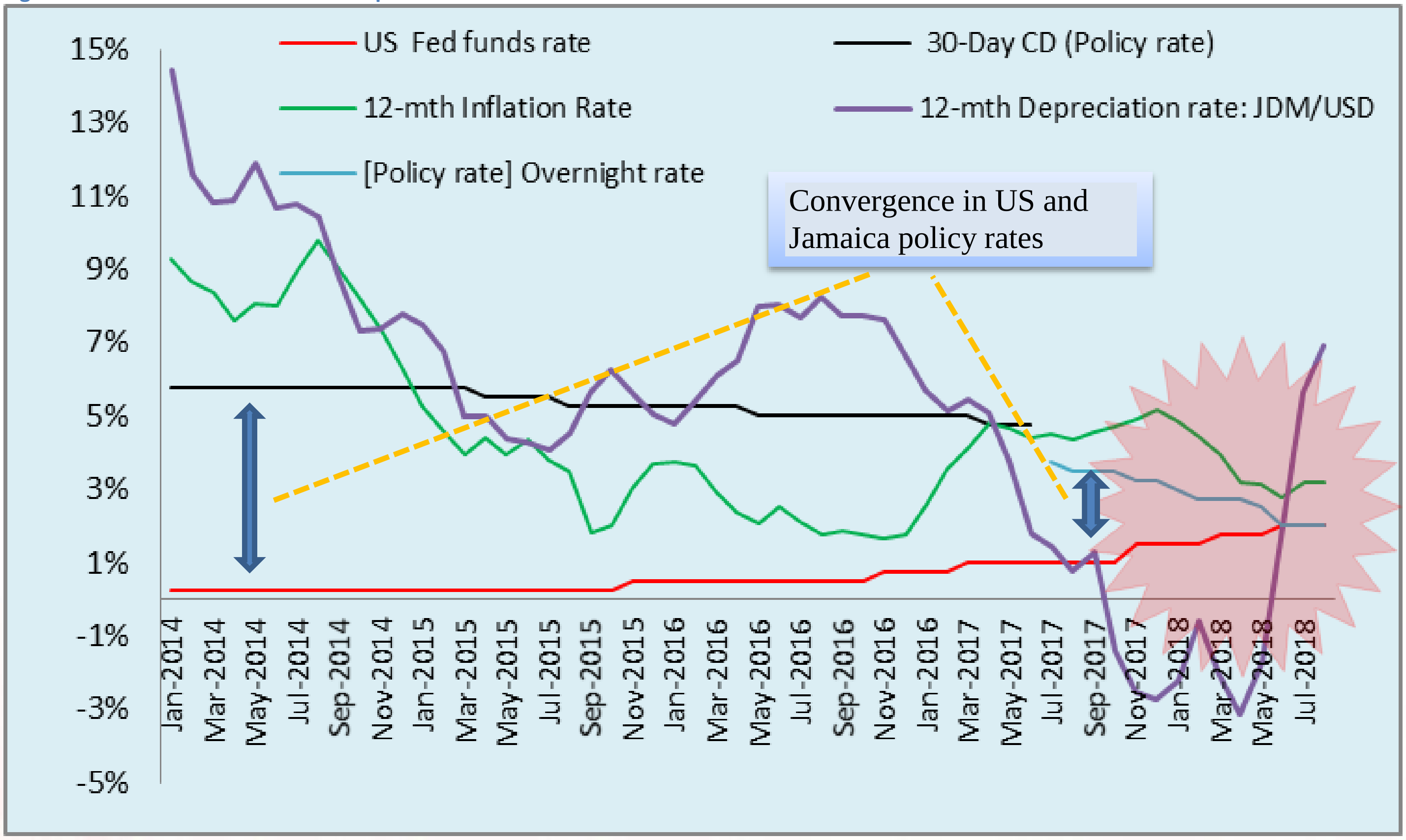
Bank of Jamaica Action and B-FXITT: Impact on the Forex Market

Monetary policy has been relatively accommodative since mid-2015, culminating in an incremental decline in the Bank of Jamaica's (BOJ) policy rate. Despite the lowering in the policy rate, wide interest rate differential between the local and US policy rates and relatively high confidence in Government of Jamaica (GOJ) economic programme led to deceleration in the pace of depreciation of the JMD, which occurred in an environment where JMD liquidity was relatively high. This in part reflected the prevailing monetary policy and less aggressive debt operations by the GOJ.

The BOJ's decision to reduce the policy rate is in keeping with its expectation regarding the domestic inflation path and to cajole financial institutions to reduce lending rates. While lending rates have declined they have not moved as aggressively as the BOJ's signal rate and Treasury bill yields. It is our view that this largely reflects minimal change in the risk profile of the economy since the International Monetary Fund backed economic reform programme and growing household debt levels (See Jamaica Opinion: Interest Rates, July 2018, for more detailed look). We pointed out that given the prevailing low interest rate environment and high JMD liquidity that one of the major macroeconomic variables will "have to give" without going into detail as to what that variable was given our responsibility to help preserve the integrity of the broad financial markets, including the foreign exchange market.

The BOJ through the foreign exchange intervention trading toolkit (B-FXITT) has sold currency in the market at various defined intervals over the last four (4) months. However, this has done little, for the most part, to ease growing pressures in the foreign exchange market, as demand for USD remains relatively high, which among other things includes a marked shift in portfolio movement away from JMD investments towards USD investments. In addition, it appears as if speculative forces have returned to the market, as persons are moving to hold USD deposits and hoard hard currency to help reserve their wealth.

Figure 2: Interest rates and 12-Mth depreciation of the JMD



Sources: Bank of Jamaica, Federal Reserve and JMMBIR

Opinion

Volatility has returned to the foreign exchange market precipitated in part by shifts in investment portfolios from JMD to USD investments. The movement in the currency has also resulted in persons hoarding foreign currency to preserve wealth and to hedge their foreign exchange exposure. In mid-August the BOJ issued a statement that the movement in the foreign exchange rate is in part due to 'positive' purchase of US dollar. Our own view is that this is among other things reference to the debt transaction involving NCB and NWC. It is instructive to note that while the GOJ removed $15 billion from its book due to the NCB transaction, the overall debt increased by more than $20 billion in June alone due to depreciation of the JMD. Thus on a net basis, the nominal debt increased by more than $5 billion during the period.

Going back to the main thesis, while the macro-economic trend is suggesting a low depreciation path, wild swings in the JMD, as observed in the last three months leading up to August, have caused speculative forces to return to the foreign exchange market. An 'academic' statement by the central bank is not sufficient to allay speculative forces. The BOJ must act, where necessary, to bring back order and confidence in the foreign exchange market. Most central banks in Latin America and the Caribbean are increasing their policy rates in the wake of rising Federal Reserve (Fed) fund rates in order to mitigate the risk of outflows from investments portfolios and to preserve conditions in their foreign exchange market. Jamaica is doing the opposite and there is no commensurate shift in the credit quality of the sovereign to facilitate this move. It is instructive to note that Fed funds rate and the BOJ policy rate are currently aligned (2%) and the differential is likely to fall into negative territory given the posture of the Fed and evolution in US macroeconomic conditions. Notwithstanding the domestic inflation path, if interest rate differentials continue to trend as observed, then it is reasonable to expect continued shifts in portfolios towards USD investments and an increase in speculative forces if the J-dollar continues to depreciate faster than expected. Thus, a policy shift is necessary to return order in the foreign exchange market, as forces have been set in motion that are hard to stymie without strong signals from the authorities given the behavioural tendencies of market participants.

APPENDIX

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