Richard Byles: Jamaica's experience with the transmission mechanism during the tightening cycle following the inflation shock

Presentation by Mr Richard Byles, Governor of the Bank of Jamaica, to the panel discussion by central bank presidents during the Inter-American Development Bank's 59th Meeting of the Network of Central Banks and Finance Ministries, Washington DC, 17 April 2024.

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Overview

My brief remarks will be focussed on Jamaica's experience with the transmission mechanism during the tightening cycle following the inflation shock. In this regard, I will be spending a moment discussing the challenges with the credit channel and the relative dominance of the exchange rate channel. This will provide insights on the Bank of Jamaica's policy response which continues to be geared at ensuring price and financial system stability. I will close by highlighting the actions the Bank is undertaking to improve the weak transmission mechanism.

To address rising inflation and heightened inflation expectations associated with the pandemic, Bank of Jamaica started tightening monetary policy in October 2021 (before most advanced economies). The Bank employed a three-pronged approach:

i. Gradually increasing the policy interest rate by 650 basis points (bps) since October 2021, from 0.5% to its current level of 7.0%;

ii. Deploying open market operations more aggressively to maintain tight Jamaica dollar liquidity conditions; (This also involved increases to the domestic and the foreign currency Cash Reserve Requirements applicable to deposit-taking institutions (DTIs) and a widening of the interest rate corridor); and

iii. Engendering greater stability in the foreign exchange market through foreign exchange intervention and adjustments to the Net Open Position limits.

In Jamaica, we have found that the credit channel, which is the main channel targeted by the Bank's monetary policy actions, has been quite weak. As such, we have observed that our policy actions geared at managing inflation expectations and the exchange rate channel have generally been more effective.

As a small open economy, that is dependent on imports with approximately 50% of consumption being imported, one can understand the imported inflation challenges for Jamaica in recent years, arising from the global macroeconomic environment. Since October 2021, while maintaining a flexible exchange rate, the Bank has therefore taken decisive actions in the foreign exchange market, primarily selling foreign exchange when necessary. Without these actions, imported inflation, and hence the final prices faced by consumers would have been higher.

A major issue during the tightening cycle was the weakness in the monetary transmission mechanism. Earlier in the cycle, the Bank observed different degrees of pass-through of its policy actions to lending and deposit rates of DTIs and the non-bank sector, with the former instituting relatively small adjustments to deposit and lending rates. We expected deposit and lending rates to respond to the increase in the policy rate with a 1 to 3 months lag after the policy adjustments and the pass-through to range between 40% and 90% over the period.

In contrast, deposit rates and lending rates have responded marginally to the Bank's 650 bps policy adjustment. At February 2024, weighted average deposits increased by only 145 bps while time deposits increased by 370 bps. Weighted average private sector loans increased by just 40 bps.

Our research has shown that the source of the weakness in the credit channel is primarily due to the concentrated nature of the banking system. This is evidenced by the dominance of two major network banks, which allows them to pay low deposit rates while maintaining their profit even when subjected to monetary policy changes. In addition, given the time-consuming process of switching financial interests from one private financial institution to another due to Know Your Customer (KYC) requirements, customers may become discouraged from changing institutions even if they believe they are not receiving the best prices and/or services. This then constrains deposit portability.

Notwithstanding the general weakness in the credit channel, we have observed a positive response of domestic inflation to the Bank's tightened policy posture. Since its peak at April 2022 of 11.8%, annual point-to-point inflation has been on a general downward trajectory, moderating to 6.2% at February and 5.6% at March 2024. This downward trend occurred in the context of lower imported prices, supported by stable exchange rate and tight Jamaica Dollar liquidity conditions.

The policy rate has remained stable at 7% since November 2022, but the tight liquidity management has led to persistently high money market rates. The financial system, however, remains stable and able to withstand shocks. DTIs are well capitalised, asset quality relatively stable and provisioning by the system adequate.

Conclusion

As I close, it is imperative that we improve the transmission system of the country. Jamaica has been exploring deposit portability and open banking as strategies aimed at improving competition in intermediation. BOJ has engaged with the World Bank for support, and we are in the process of developing a policy framework to promote and regulate an e-KYC database for the sharing of customers' transactional and non-transactional data. The Government of Jamaica is also in the process of developing a National Identification System (NIDS) which will provide a quicker method of identity assurance and verification thus making it easier for banks to onboard customers.