Monetary Policy “Alternatives” in the Face of a Dysfunctional Transmission Mechanism*

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ABSTRACT

Jamaica has made significant progress in recent years in reducing inflation and consequently, the average levels of nominal interest rates. These interest rates, which further declined to near record levels following the implementation of a debt exchange programme in 2010, are also expected to remain relatively low. Notwithstanding these declines, lending rates in commercial banks have remained sticky, with spreads of over 11 percentage points above the Central Bank’s policy rates at end-December 2010. Concurrently, there has been a fall in demand for loans at these rates as the balance sheets of households and businesses continue to be constrained by the impact of a weak domestic economy. Given that commercial bank rates to the private sector remain sticky, reliance solely on the policy rate could prove ineffective in stimulating aggregate demand. In this regard, the paper examines “alternatives” to supplement the traditional interest rate tool used in Jamaica. The paper suggests that there could be some merit in the increased use of macro-prudential policy tools as well as the expansion of the Central Bank’s balance sheet, areas that have gained considerable attention since the global financial crisis which emerged in 2007. There is also some room for fiscal policy, but this is limited in a context where fiscal policy is constrained in Jamaica.

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The views expressed herein are those of the author and should not be attributed to the Bank of Jamaica.

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Introduction
The global financial crisis, which had its genesis in 2007, had a debilitating impact on the global economy. Central banks across the world, faced with a near collapse of their financial systems and a sharp decline in output, were forced to adopt unconventional monetary policies to ensure the proper functioning of markets. In some countries, interest rates were also brought down to unprecedented levels or near the zero bound but output and prices did not respond as anticipated. Consequently, discussions have emerged on the effectiveness of the policy rate as the only instrument as well as the cost and benefits of non-traditional tools of monetary policy. In general, the crisis has forced central banks globally to question whether or not the consensus on monetary policy that obtained prior to the crisis holds and has led individual central banks to examine alternatives that could be used to supplement the policy rate.

Following the crisis, the Bank of Jamaica (BOJ) also adopted a suite of policy measures, most of which were unconventional. However, in contrast to most central banks which injected liquidity in the domestic system, the BOJ’s policy responses had a net impact of withdrawing liquidity from the system. The measures undertaken by the BOJ were primarily aimed at restoring stability to the foreign exchange market and ensuring the smooth functioning of the financial markets. After increasing rates for a short period, interest rates were brought down to rates not seen in 30 years, partly due to the implementation of a debt exchange programme, the Jamaica Debt Exchange (JDX), in 2010 and the favourable outlook for inflation.¹

¹ The JDX was implemented in February 2010 and entailed a programme where holders of Jamaica Government domestic denominated securities voluntarily agreed to exchange them for securities with lower interest rates and longer tenors.
The major institutions supervised by the BOJ, the commercial banks, were relatively unscathed by the crisis. This was mainly due to measures put in place subsequent to Jamaica’s financial crisis of the mid-1990s which reduced their vulnerability to risks. In fact, some of the prudential requirements implemented in the mid-1990s were much more stringent than international norms and have not been loosened since.

Notwithstanding the significant reduction in the policy rate, commercial banks have been reluctant in lowering interest rates, leading to an increase in spreads from pre-crisis levels. At end-December 2010, for example, commercial bank lending rates were in excess of 11 percentage points above the BOJ policy rate of 7.5 per cent in comparison to a spread of 9.8 percentage points at end-2006 (see Appendix, Chart 2). The maintenance of high and sticky interest rates in the banks, has led the BOJ to question the effectiveness of its policy rate.

In this regard, the aim of the paper is to examine the conduct of monetary policy in Jamaica juxtaposed against the current debates in the literature. Given the appearance of a dysfunctional transmission mechanism, the paper examines “alternatives” to supplement the traditional interest rate tool, with a view to enhancing the transmission of lower interest rates to the private sector.

The paper finds that there is some merit in using macro-prudential policy tools and quantitative easing, areas that have gained considerable attention since the global recession of the late 2000s. Included in the macro-prudential policy tool kit are some fiscal policy
measures that could be implemented, without jeopardizing the fiscal targets outlined in the International Monetary Fund Stand-By Arrangement (IMF-SBA).²

Risks likely to materialize from these initiatives include reputational risks from a worsening of the central bank’s profitability position and an expansion in its balance sheet. The latter could be misread to mean that the BOJ has lost its commitment to low and stable inflation. These risks, however, can be appropriately managed through effective communication strategies, aimed at anchoring long-term inflation.

The remainder of the paper will begin with a brief review of the literature on monetary policy, focusing on the discussions that have evolved in the post global recession period of the late 2000s. This will be followed by a discourse on the conduct of monetary policy in Jamaica which will precede the conclusions and policy recommendations.

Literature Review

Most of the major central banks within the past decade, have generally conducted monetary policy by targeting or setting nominal short-term interest rates. These short-term rates, for the most part, have been the overnight rate. Other central banks, while having an overnight rate, concentrate on a rate of a longer tenor as its main policy instrument. The European Central Bank and the Bank of Jamaica are examples. The general consensus is that changes in the policy rates influence other interest rates in the system such as money market rates and subsequently loan rates to the private sector. These rates in turn influence aggregate demand which is eventually transmitted to prices.

² Jamaica signed a 27-month IMF-SBA in February 2010.
Prior to the global financial crises of 2007-08, the general view on monetary policy was that the central bank would always be able to influence aggregate demand and prices by adjusting interest rates. The consensus was that this could be achieved through inflation targeting, which provided a sound framework to systematically analyze and discuss monetary policy. This framework is characterized by an explicit commitment that low and stable inflation should be monetary policy’s primary goal. In this regard, short-term interest rates (in most cases an overnight rate) were manipulated in order to meet the inflation target (level or range). Under the regime, inflation was targeted at a short and fixed horizon.

The inflation targeting framework does not entail an intermediate target such as money, but uses the inflation forecast itself as the intermediate target. Economic models were therefore developed which paid little attention to the development of the money and credit aggregates but relied on a form of the Taylor Rule. In fact, the impact of money and credit was totally disregarded in most models as the policy framework focused on the deviation of inflation from the target. A lot of weight was placed on the output gap in forecasting inflation. In a context where it was believed that central banks could always avoid deflation by lowering interest rates, there was not much concern about the policy rate being ineffective at relatively low interest rates.

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3 Consequently, traditional tools such as reserve requirements were deemphasized by a number of central banks in both developed and developing countries. In more extreme cases, a number of countries including Canada, United Kingdom, New Zealand, Japan and Australia had fully eliminated reserve requirements as a tool to reduce inflation. See Buzeneca and Maino (2007) for a survey of central banks.

4 See Martinez (2008) for a discussion on how this framework has influenced the development of monetary policy in emerging markets. See also Bernanke (2003) as well as Mishkin and Schmidt-Hebbel (2007) for useful discussions on inflation targeting.

There was also consensus that asset prices should affect monetary policy only to the extent that they helped to predict prices. In this regard, it was felt that there was no need to respond to asset price bubbles and monetary policy should only play a role after the burst of the bubbles (Blinder 2005). Issing (2008) suggests that the Jackson Hole Consensus was exactly this view.

It was also the consensus that fiscal and monetary policies should be separated. In this regard, the framework also stressed the importance of central bank independence and transparent communication in order to anchor long-term inflation.

Another important consensus that obtained prior to the crisis was that the supervision of financial institutions should be undertaken from a micro-prudential perspective as it was the health of individual financial institutions that mattered. There was also a view that the supervisory aspects of a central bank should be separated from its macroeconomic aspect and it would be ideal if these functions were allocated to different policy authorities.

The global financial crises of the late 2000s provided a robust test for this framework. The devastating impact on output, prices and the stability of the system highlighted that there were shortcomings in the framework and hence some of the tenets of the framework were in need of revision. These include the systematic disregard for money, credit and financial assets in the determination of risks to price stability and the heavy weight placed on the output gap under a Taylor Rule framework, in the determination of interest rates. In addition, the definition of price stability objectives as point targets over a short horizon and the use of
interest rates as “the instrument” to achieve these objectives have been questioned, warranting central banks to look more keenly at how monetary policy is conducted. While the paper does not have room to discuss all aspects of the current debates, those particularly relevant to the paper are highlighted.

As it relates to the instruments used by central banks, consensus seems to be emerging that the use of interest rates is not the panacea to achieving the central bank objectives. Rather there appears to be a strong role for the use of “non-standard” policy alternatives. Some of the non-standard measures being debated had reemerged for discussion prior to the onset of the crises but did not gain traction as the occurrence of the zero bound was considered to be highly unlikely (for example, see Bernanke, Reinhart and Sack 2004). These non-standard measures were grouped into three classes: (1) using communications policies to shape public expectations about the future course of interest rates; (2) increasing the size of the central bank’s balance sheet; and (3) changing the composition of the central bank’s balance sheet.

These non-standard measures have been a feature of a number of central banks since the onset of the crisis in 2007. Some of these measures were also used in the past. For example, the expansion of the central bank’s balance sheet (quantitative easing) was used by the Bank of Japan in the 1990s. One of the lessons learnt from that experience is that policy makers did not loosen policy enough to account for the downside risk of falling prices. This was in a context where it was felt that if the economy rebounded on its own accord, then a further loosening could have had adverse consequences (Ahearne, Alan et. al. 2001). Consequently, if too little stimulus is provided, the future ability of monetary policy to pull the economy out
of its slump can be substantially undermined. In this regard, they opined that both monetary and fiscal policy should go beyond the levels conventionally implied by baseline forecast of future inflation and economic activity.\(^6\)

Another area of interest in the current debate, relates to the supervision of financial institutions. A number of conferences, speeches and papers have highlighted the issue and a consensus seems to be forming that the supervision of financial institutions should go beyond focusing on a micro approach, which takes account of the health of individual financial institutions, to focus on an approach such that changes in capital requirement and related supervisory tools are coordinated with monetary policy. In this regard, the supervisory role should take on a more macroeconomic approach through the use of macro-prudential policies.\(^7\) Consequently, it is now the view that the central bank should play a key role in the supervision of financial institutions.

Macro-prudential policies seem to focus on financial stability or containing systemic risks, rather than risks to individual financial institutions (Moreno 2011). In addition, macro-prudential policies also focus on the interaction between macroeconomic conditions and the financial system as well as the possibility of dampening procyclicality in the financial system.

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\(^6\) Ahearne noted that fiscal policy focused on public works, roads and bridges in home districts of legislators, rather than investments in more visibly productive projects, which would have raised productivity and increased confidence in the future growth of the economy.

\(^7\) See Galati et. Al (2011), Moreno (2011), Banca D’Italia Workshop and Conference (2009), BIS Conference
The Governor of the Bank of Japan, Shirakawa (2009), has argued that the current regulatory and supervisory framework does not have the effective mechanisms and instruments necessary to control the inherent procyclicality of the financial system. He further argued that measures against procyclicality need to address the build-up of financial imbalances in upturns and their subsequent unwinding in downturns from a system-wide perspective. This will ensure financial system stability through serving as a shock absorber, instead of a transmitter of risk to the broader economy, thus functioning as an automatic stabilizer of boom-and-bust cycles.

One of the areas in which macro-prudential policies can be used to address cyclicality is private sector credit. In explaining the cyclicality of credit, Hilbers, et al (2005), based on the accelerator principle, noted that credit expands more rapidly than GDP at the beginning of a cyclical upturn due to firms’ investment and working capital needs. On the converse, if asset prices and collateral values are depressed or fall below expectation, the indebtedness of the borrowers will increase, decreasing both their capacity to service their loans and their access to new loans. He noted that these factors play a great role in extending a boom and increasing the severity and length of a downturn.

Jimenez (2006) noted that bank supervisors are convinced that bank lending mistakes are more prevalent during upturns than in downturns. He concluded that during upturns, both lenders and borrowers are overconfident about investment projects and their ability to repay and recoup their loans as well as the corresponding fees and interest charges. Increasing
competition and strong balance sheets during upturns lead banks to take on projects, even with negative NPVs. The opposite happens during a recession.

Further work by Jimenez et al (2008) noted that following a monetary expansion, in addition to a higher appetite for liquidity risk, banks also take on more credit risks. He noted that this supported the work of Stiglitz and Greenwald (2003), Diamond and Rajan (2006) Dell’Aricca and Marquez (2006) and Borio and Zhu (2007). In his explanation, Jimenez found that lower interest rates reduce the credit risk of outstanding loans. This is possibly the case as refinancing costs are lower and borrowers’ net worth is higher, therefore credit risk is lower. Consequently, there is a completely different impact on lower interest rates on the credit risk of new vis-à-vis outstanding loans. Therefore in the short-run, lower interest rates reduce total credit risk of banks since the volume of outstanding loans is larger than the volume of new loans. Reducing interest rates lowers the credit risk of all outstanding loans, making banks more willing to again accept credit risk, thereby reducing the tensions in the credit markets.

Macro-prudential tools that have been applied to address the credit cycle, the area of interest to this paper, include:

1. Loan to value ceilings (used in Korea and Canada, recently)
2. Debt to income or debt service to income rules, that would tend to ensure that credit flows to those with a greater ability to repay (used in China, Korea, Thailand and Malaysia in the 1990s)

8 The literature points to herd behaviour in helping to explain why projects with negative NPVs are taken on during booms. Credit mistakes are judged more leniently if they are common to the whole industry.

9 Bernanke, Gertler and Gilchrist (1996) also pointed to the possibility that lower interest rates, by improving borrowers net worth, may result in banks lending to borrowers that were deemed risky in the past.
3. direct measures to limit/expand credit
4. reserve requirements
5. taxes on lending (lowered in Turkey in 2009 to boost consumption)
6. targeting certain sectors eg use of rebates in reserve requirements to encourage purchases of bank assets and of foreign currency
7. risk weights on banks’ exposure to certain types of loans eg consumer, real estate.

Debates have even surfaced as to whether or not central banks should increase direct lending to the real economy. It is argued that this is not a theoretical subject in a context where the Federal Reserve, for example, established a liquidity facility directed to non-banks including issuers of commercial paper (González-Páramo 2009).

The Conduct of Monetary Policy in Jamaica

Jamaica is a small open economy in which prices are subject to frequent exogenous shocks such as hurricanes and other adverse weather conditions. The country has experienced high annual point-to-point inflation which peaked at 107.9 per cent in April 1992. This high level of inflation was mainly transmitted through the exchange rate subsequent to the liberalization of the foreign exchange market. Since then, annual inflation has declined to more moderate levels through the use of tight monetary policy and was 7.2% as at February 2011, following two consecutive months of deflation.

By law, the main objective of monetary policy in Jamaica is to influence the volume and conditions of the supply of credit so as to promote the fullest expansion in production, trade and employment, consistent with the maintenance of monetary stability in Jamaica.\(^{10}\) The

\(^{10}\) See http://www.boj.org.jm/supervised_legislation.php
Bank has over the years interpreted this to mean that price stability should be its major objective as low and stable prices could provide the foundation necessary for growth and employment. The current aim is to bring inflation down to that of the country’s main trading partners.

In order to achieve its inflation objective, the Bank of Jamaica, since 1996, has used base money targeting as its monetary policy framework. A lot of attention is also paid to the exchange rate given the openness of the economy and the impact of the exchange rate on prices. The policy regime is framed within a medium-term financial programme, which takes account of the monetary, external, fiscal and real sectors. In recent years, increased attention has also been paid to the financial stability of the overall system and its impact on the monetary policy objective.

The framework entails the daily interaction of monetary analysis with market intelligence and operations. Close attention is paid to the balance sheet of the Central Bank through daily monitoring of the developments in the accounts. Developments and prospects in the money and foreign exchange market as well as developments in the Governments cash flow, feed into an assessment of the impulses to base money and inflation. Decisions are taken on a daily basis as to the level of open market operations required and whether or not the Bank needs to intervene in the foreign exchange market.

Open market operations (OMOs) are the major tools used and mainly entail the use of the Bank’s own certificates of deposit (CDs). Effective January 2010, the 30-day CD became the
only tool as all other tenors were withdrawn to allow a yield curve for Government instruments to develop following the implementation of the JDX. Prior to that, policy was conducted with OMO securities which had maturities of up to one year. In addition to its CDs, the Bank occasionally sells securities from its holdings of Government instruments.

In addition to the use of OMOs, deposit taking institutions (DTIs) are required to maintain a specified level of cash reserves with the Central Bank. However, the requirement did not vary much in the years preceding the global financial crisis. The requirement is imposed as a specified rate applied to the prescribed liabilities of DTIs. Although the rate is standard across all DTIs, building societies are given an exception in that a lower rate is applied as an incentive for those that meet a qualifying ratio of mortgage loans to savings funds. For all DTIs, the cash reserves form a part of an overall liquid assets requirement.

The Bank operates on the premise that changes in interest rates affect the level of OMOs and the monetary base. 11 This in turn has an impact on the money supply and the exchange rate, and interest rates in financial markets. These rates affect spending pattern and production through the cost of credit which then feeds through to the price level. The extent and timing of the response depends on the expectations of borrowers and lenders.

Care is taken to minimize large swings in the exchange rate given the estimated impact of the pass-through to prices. Research undertaken by the BOJ has shown that the main transmission channel of monetary policy in the Jamaican economy is the exchange rate.

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11 In addition to the rate on the 30-day CD, the Bank also has an overnight deposit facility. The rate on this facility however does not vary much and has no relationship with its main policy rate.
(Allen, Hall and Robinson (2002)). More recent research (Robinson and Allen 2004) found that 78.0 per cent of the impact of a 1.0 per cent increase in the Bank’s interest rate on inflation would be transmitted via the exchange rate channel. Most of the impact is felt within 6 months with full pass through felt within 18 – 24 months.

Although base money targeting remains the official framework of the Bank, the institution over the years has adopted several elements of an inflation targeting framework. At the reading of the fiscal budget, an inflation target is announced by the Minister of Finance. This target is arrived at in consultation with the Bank. The target is derived from the Bank’s macroeconomic model which incorporates developments in the international and domestic economy that are likely to have an impact on inflation. After applying some judgment to the model, it sets out a path for the Bank’s policy rate consistent with delivering the inflation target. Policy discussions, have in recent years, put a lot of weight on any potential deviation from the announced inflation target, while paying close attention to the developments in the monetary aggregates.

Over the years, a comprehensive assessment of developments in different sectors has been done at a weekly Economic Policy Committee Meeting (EPC). Prior to late-2010, assessments were done in an ad hoc manner based on available data and did not view all the sectors simultaneously. However, since late-2010, every month a specific meeting has been dedicated to discussing monetary policy action. At this meeting, developments in all the
sectors are reviewed. A report is prepared with a recommendation which is then discussed at a high level policy committee. The final decision is then taken at this meeting.

Further, in recent years, the Bank has attempted to increase the transparency of its monetary policy actions and shape public expectation of future policy actions by increasing its communication to the market. A press conference is held at least once per quarter in which the Bank releases its Quarterly Monetary Policy Report (QMPR) outlining the main factors that influenced inflation during the quarter. The QMPR also presents the Bank’s perspective on future economic trends from which the market is able to discern monetary policy actions over the short-term. The inflation forecast for the quarter is also given in the report. In addition, the Governor participates in numerous events in which speeches are made on the Bank’s commitment to low inflation.

With respect to the current monetary policy debates, the BOJ has never subscribed (publicly) to certain aspects of the consensus while there were other aspects that were endorsed and practiced. In particular, the very foundation on which the financial programme is based, dictated that there could have been no systematic disregard of money and credit indicators in the conduct of monetary policy. Developments in these aggregates in nominal terms were closely watched and used to make inferences about the state of the economy and likely pressures on inflation. However, in the determination of the monetary policy action in recent years, more weight has been placed on the output gap and the projection of inflation

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12 The Bank does not have an official Monetary Policy Committee comprising of external members, hence all decisions are based on internal discussions. The high level committee meeting comprises five members, chaired by the Governor while the EPM Meeting is a much larger body, chaired by the Deputy Governor of the Research and Economic Programming Division.

13 Some of the findings were often disregarded by the proponents of an inflation targeting regime.
itself relative to the target. Inflation is targeted at a short horizon, usually a year, and quarterly projections of inflation are also released to the public. In recent years, the Bank also adopted the use of a Taylor rule type framework to estimate short-term Treasury bill rates. This is used as a guide in setting the Bank’s policy rate.

A significant amount of weight is also placed on the exchange rate movements given research which showed the large impact on inflation. In this regard, the foreign reserves have been used to smooth exchange rate changes, with care that the reserves do not fall beyond a certain level.

The Bank has never articulated a view on the treatment of asset price bubbles. However, the Bank monitors development in the stock market and reports on these developments in its QMPR. Little attention has been paid to other asset prices, partly due to data constraint. For example, housing prices from a wide cross section of the economy are garnered from anecdotal information.\textsuperscript{14} These are sometimes discussed but not with a view of designing policy specifically to influence them.

\textit{Response to the Crisis}

The Bank of Jamaica responded to the various challenges from the global financial crisis with a suite of monetary policy actions, some of which were unorthodox. These temporary policy measures were all aimed at augmenting the supply of foreign currency and facilitating the flow of credit. The measures implemented included:

\textsuperscript{14} The Bank is in the process of developing a housing price index.
i. The establishment of a Special Loan Facility in foreign currency on 15 October 2008 for security dealers and other institutions with foreign currency needs to repay margin calls on GOJ global bonds.

ii. The establishment of a Deposit/Loan Intermediation Facility in foreign currency on 12 November 2008, to facilitate the flow of credit in the system. The facility entailed taking foreign currency deposits from institutions and on-lending these to other institutions. This was later extended to include deposits and loans in local currency.

iii. Increasing interest rates across the spectrum of open market instruments on 17 October and 01 December 2008.

iv. The offer of a special 15-day CD to primary dealers and commercial banks on 18 -19 November 2008.

v. An increase in the statutory cash reserves requirement from 9 per cent to 14 per cent.

vi. Intervention sales in the foreign exchange market.

vii. More frequent and transparent communication to the market.

One of the noticeable features of the response (in contrast to various central banks) was the absence of a liquidity stimulus. The impact of the intermediation facility in (ii) on the system was neutral as liquidity was simply taken from supervised financial institution and on-lent to institutions not supervised by the BOJ as there was uncertainty about the riskiness of these institutions. Hence, the net impact of the policy actions was to withdraw liquidity from the system and a general tightening of monetary policy. These policy actions assisted in restricting the pace of depreciation in the exchange rate to 12.24 per cent for 2008. Inflation for that year was 16.8% and without the implementation of these measures, inflation would have been much worse.

Although the Bank did not articulate an exit strategy at the time of implementation of these measures, the facilities were easily wound up as the institutions emerged relatively unscathed.
from the crisis. Monetary policy has been subsequently loosened with interest rates falling to near record lows. The CRR, however, has not been returned to pre-crisis levels.

**Lessons Learnt from the crisis**

In order to proceed with effective monetary policy following the crisis, it is essential to examine the lessons learnt from the crisis. My views are the following:

1. The role of frequent and effective communication is essential in soliciting cooperation from the market and in getting market players to understand the Central Bank’s actions. It is believed that the depreciation in the Jamaica Dollar and consequently inflation, would have been much worse, had it not been for frequent discussions with authorized dealers. In these meetings, the impact of any adverse behaviour on their part on the overall stability of the system and the health of their own institution were explained. Consequently, a decision was taken by authorized dealers to enter into a foreign exchange rate pact, whereby bids in the foreign exchange market fell within a certain range, during a particular period.

2. Consensus is important, especially in matters that affect major players. The success of the JDX is a case in point as market players understood the benefit to be derived from participating in such a programme. The foreign exchange market pact in (i) was also developed given the consensus that it was in the interest of all to minimize impulses to inflation.

3. Fiscal and monetary policy coordination is essential. For example, the withdrawal of BOJ’s longer term CDs from the market allowed for the development of a yield curve for GOJ instruments in line with JDX yields. The provision of liquidity to the Government during the period also allowed for the smooth functioning of financial markets and was not viewed as a deviation from the commitment of low inflation as this was transparent and properly explained to the market.

4. The stress tests conducted by the BOJ were validated as, for the most part, the DTIs were able to withstand the shocks from the global economy. There was no request from

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15 The debt became more unsustainable due to the impact of the crisis on the fiscal accounts.
any of the DTIs for liquidity support from the central bank during the period.\footnote{Excluding the margin loans, which were concentrated.} All DTIs remained well capitalized and, for the most part, capital and profitability ratios remained strong. Further stress tests continue to show that DTIs are able to withstand significant shocks.

\textit{In crisis periods, the central bank will take on the lender of last resort role, even to institutions not under its supervision. For example, the margin loans facility was extended to all financial institutions, including those not supervised by the BOJ. This move was necessary to ensure the stability of the foreign exchange market, given the potential impact of the exchange rate on inflation. Such policies, however, should not be a standard feature of the central bank due to moral hazard problems and hence should only be used in the event of emergencies.}

\textit{Given that the central bank will take on the lender of last resort role to all financial institutions, in extenuating circumstances, then balance sheet information about the financial conditions of all financial institutions in the system should be available to the central bank on a frequent basis.}

\textit{While not losing sight of the inflation objective, unemployment and GDP growth need to be taken into consideration in setting monetary policy.}

\textit{Traditional instruments, such as reserve requirements, that have been deemphasized, should not be abolished. Rather, they should take on a more cyclical role in supplementing the interest rate instrument, that is increase them during booms and reduce them during busts.}

\textit{Jamaica has undergone a paradigm shift. Excess liquidity will not necessarily fuel demand for foreign currency, even at relatively low interest rates. In addition, levels of interest rates that could be once considered loose may now be relatively tight given a similar set of challenges.}

Jamaica is now under a 27-month IMF-SBA, signed in February 2010. All efforts have been made by the authorities to achieve the targets set out in the programme. Concerns however abound regarding the state of the real economy, especially in a context where the monetary
policy transmission appears to be dysfunctional. Abstracting for the impact of increases in international grain and oil prices, impulses to inflation remain weak with reductions in the price of some commodities.

Notwithstanding the substantial reduction in the policy rates, spreads in commercial banks remain high as these institutions continue to enjoy relatively large profit ratios. The ROAs and ROEs, in most instances have also outperformed other banks globally (see Appendix Tables 1 and 2). These high interest spreads have generated net interest margins averaging 8.5% over a five year period ending 2010. The demand for loans at rates underlying these spreads has fallen significantly since the crisis (see Appendix Chart 3). Spreads over the policy rates have also widened relative to the pre-crisis period, possibly reflecting the increased riskiness of borrowers and, for the most part, continue to reflect the impact of high operating costs (see Appendix Chart 2). This increased risk is reflected in substantial deterioration of balance sheets of households and businesses and increases in non-performing loans (see Appendix Chart 4). In this regard, outside of a few loans at much lower rates to ‘good’ borrowers, there is reduced willingness of banks to take on additional risks while businesses and households have reduced their desire to take on more debt at these high interest rates. These conditions (known as a balance sheet recession) are all likely to impair monetary policy.

**Recommendations/Policy Response**

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17 There was however some disparity among banks, as the performance of some banks was below international norms.

18 This situation contrast significantly with former years when businesses and households were willing to take on debt at even higher rates. For the 5 year period preceding the crisis, private sector credit growth averaged 27% while loan rates averaged over 24%. 

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The paper is not in support of some of the direct measures proposed in the literature or elsewhere to supplement the central bank rates. For example, consequent on the apparent failure of the pass-through of the policy rate to lending rates and the attendant weak demand for bank credit at these rates, some sectors of the society have argued that the BOJ should exercise its powers under section 33 (1) (a) of the BOJ Act. This section of the Act allows the BOJ to determine the maximum lending rates at which the banks are allowed to lend. The BOJ is, however, of the view that the use of these powers should be reserved for emergencies and catastrophic situations given the long-run reputational effects of government intervening in setting prices in a market economy.

In my view, policy responses that could be used to augment the traditional interest rate tool include a mix of monetary, administrative and macro-prudential measures. There is also some room for fiscal policy but this is limited in a context where fiscal policy is constrained in Jamaica. In addition, there is much room for improving the Bank’s communication in order to anchor long-term inflation.

Commenting on these in reverse order, the Bank of Jamaica over the years has greatly increased its credibility for reducing inflation. This is partly due to the improvement in the transparency of monetary policy. Inflation expectations are, however, not well anchored as the public changes its expectations of inflation when there are temporary deviations from the quarterly forecasts. For example, the market will increase its expectations for inflation following an agricultural or oil shock to prices and hence cast doubt on the projection from the Bank. The anchoring of inflation expectations is crucial as it makes the work of the central
bank easier. If the public is of the view, that the Bank is committed to the target, this will more likely moderate price pressures from wages and other sources relative to a situation where the central bank is not seen as being committed. Such a view would contribute to a reduction of uncertainty and facilitate better planning in the economy.

In keeping with the literature, the Bank should also discontinue the short-term inflation forecast, especially the quarterly forecasts which are usually given to the public. Less emphasis should also be placed on the one-year forecast while concentrating on the medium-term forecast. An appropriate communication strategy would need to be designed to explain the reason for such a change in order to avoid the perception that the central bank is being less transparent. This perception would likely be formed especially at a point when international commodity prices are rising. Temporary spikes that are expected can be highlighted without giving a short-term forecast. This would assist in focusing the public’s attention away from the quarter and even the year to a longer term outlook for inflation. Responding too much to short-term deviations could overcorrect the policy required to achieve the long-term goal. Efforts should also be made to make the central bank’s policy framework more explicit, with the objective of having a convergence of views towards that of the central bank.

1) Fiscal Measures

The use of expansionary fiscal policy in Jamaica is limited given high levels of debt as well as the targets outlined under the IMF-SBA Programme.\textsuperscript{19} However, Government could substantially reduce the stamp duties associated with the transferring of loans and mortgages from one financial institution to another. The removal of these costs would make it more

\textsuperscript{19} At end-December 2010, Jamaica’s debt/GDP ratio was estimated at 123.9%.
feasible for individuals to refinance loans at a lower rate thus reducing the overall riskiness of the loan portfolio. The argument is that with lower rates individuals would be in a better position to service existing loans. It is estimated that the income foregone by the Government would be minimal as loans are infrequently transferred due to the cost of doing so. The removal of such costs would make it cheaper to refinance loans and stimulate competition within the sector.

2) Macro-prudential policy tools

Based on the literature, macro-prudential policy tools are considered to work effectively by making use of their nature as automatic stabilizers of boom-and-bust cycles. The reserve requirement is one such tool mentioned in the literature. In recent years, the BOJ has only used the reserve requirement under extenuating circumstances. For example, early in the crisis, the cash reserve requirement was increased by 5 percentage points to address instability in the foreign exchange market. The reserve requirement has since been reduced but not to pre-crisis levels. In a context where the reserve requirements can be viewed as a tax on intermediation and contribute to the loan spread, then lower reserve requirements should translate to some reduction in loan rates, however marginal. The current situation requires a cash reserve level that is looser than the pre-2007 crisis given the relatively weak economy. Excluding the impact of international commodity prices on domestic inflation, prices in general appear to be depressed due to weak aggregate demand. In a context where balance sheets are weak and there is the possibility of further job reductions, inflation must be closely watched as deflation is possible, even in a country like Jamaica, which is susceptible to shocks.

The concept of a differentiated cash reserve requirement could also be explored. This is already practiced in Jamaica for the building societies where institutions with a qualifying ratio of 40
per cent and over for mortgage loans to assets are required to hold 1 per cent CRR relative to a requirement of 12 per cent otherwise. A similar arrangement could be made for the commercial banks. These measures could be reversed when the economy recovers and concerns for money growth inflation emerge. It is also suggested that, although banks are holding large excess reserves, the liquid asset requirement is reduced as this provides an incentive to acquire short-term instruments relative to granting loans.

Most of the other macro-prudential tools aimed at addressing private sector credit are not recommended given the culture in Jamaica. For example, there are no requirements as it relates to a loan to value ratio in Jamaica. The imposition of such a ratio at this time would not be viewed favourably by the market. A similar view obtains for the imposition of debt service to income ratios or some of the direct measures to influence credit.

The variation in capital requirement is an area that is also highlighted as an alternative measure to address procyclicality. The capital requirement in Jamaica has, over a number of years, been 2 percentage points above the international benchmark and banks have also held capital above the requirement. While the paper is not advocating a reduction in the ratio, questions are being raised as to whether or not a one percentage point reduction in the requirement, for example, would encourage banks to take on more credit risks through lower interest rates.

4) Monetary Measures

Another non-standard measure of monetary policy that could possibly be implemented in Jamaica is the purchase of GOJ debt on the secondary market. Banks have claimed that they

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20 Banks currently hold 38% of its assets in private sector loans.
decide on a spread over the GOJ 5-year instrument in order to determine loan rates. In this regard, the BOJ could target the purchase of GOJ bonds in this range with the objective of stimulating demand for the bonds and hence lower yields, particularly on this tenor. The success of this, however, requires coordination with the fiscal authorities. The BOJ would need to signal to the market its intention to purchase the bonds on the secondary market with an exit strategy in mind.\textsuperscript{21} Such a strategy could also reduce the general market demand for short-term bonds thus helping the Government to elongate its debt maturities and prevent bunching of maturities in the short-term. The timing of the purchases has to coincide with a period in which the Government is not strapped for financing such that this would not be regarded as indirectly monetizing government deficit. Such a policy could also assist in the restructuring of the Central Bank’s balance sheet to allow for more flexibility in monetary policy and an improvement in profitability. The proposal is tantamount to quantitative easing, in which the central bank provides liquidity to the system beyond what is needed. In the context of weak demand pressures, the monetary expansion is not likely to result in an overheating of the economy.

Currently, there is sufficient liquidity in the banking system to fund both the private sector and government without causing undue pressures on interest rates. However, in the current environment where balance sheets are in recession, the demand for loans at existing lending rates will remain weak. It is likely that banks will lower interest rates to attract new loans only to the extent that they can guarantee current profitability. Such a guarantee might be more easily achieved through the alternatives outlined to interest rate.

\textsuperscript{21} A volume limit could be set which bears some relationship to the expected interest receipts on the entire holdings of Government securities for the year.
References


González-Páramo, José Manuel. (2009) “Beyond the financial crisis: Some issues on the future of central banking.” Speech given at the Inaugural Conference of "Cátedra Fundacion Ramon Areces de Distribucion Comercial” at the University of Oviedo


APPENDIX

Table 1

<table>
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<tr>
<th>Country</th>
<th>2005</th>
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<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
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Source: Global Financial Stability (October 2010)
1BOJ
2 Source: CCMF

Table 2

Comparative Analysis of Return on Equity for Specific Banks by Country

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<th>Bank</th>
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<th>2008</th>
<th>2009</th>
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Source: Bloomberg Global Financial Database, published annual financial statements of Commercial Banks in Jamaica