Why Did the Bank of Jamaica Raise Rates?

We all pay attention to inflation, whether we realize it or not and wonder when and by how much prices will go up. Inflation expectation, according to economic theory, is one of the most important predictors of inflation. We know households pay keen attention to inflation and use the information on past inflation as well as future inflation expectation to influence wage negotiations, current and future spending, and investment decisions, while businesses use it to determine whether and by how much to raise output prices. Unsurprisingly, central bankers and other policymakers, whose job it is to help households and businesses make those decisions by promoting stable prices, also monitor inflation trends and make corrective decisions if and when things appear to be going off course.

The Bank of Jamaica's (BOJ) Monetary Policy Committee recently unanimously decided to raise the policy interest rate by 100 basis points to 1.50 per cent per annum. The Committee also signalled that they intend to raise the policy rate at subsequent policy meetings if inflation and other macroeconomic variables continue to evolve as projected. The fact that inflation breached the upper limit of the bank's target range in August 2021 most likely weighed heavily on their decision. Despite this, central banks are usually more concerned about the future, and the committee expressed concern that inflation might continue its upward trend (continue off course) over the next two years.

The BOJ's decision to "tighten" has been met with widespread criticism from several stakeholders, which is unsurprising. The move to increase the policy rate comes at a time when the economy is still vulnerable, with unemployment high and the population's vaccination rate low when compared to our regional peers. Furthermore, the fact that other countries, such as the United States (US), have not moved to raise rates despite experiencing stronger economic growth adds weight to the argument. But what if inflation is not as transitory as we thought? In their recent statements following the rate hike, the BOJ attempted to make this point. They also reaffirmed their commitment to ensuring that a macroeconomic environment that promotes growth is in place, as set out in their "single-mandate".

When the BOJ first hinted at raising rates in August, they also predicted that the increase in inflation would be temporary, a view shared by the US Federal Reserve and many economists. In most cases, monetary policy can see past transitory spikes in inflation and often uses moral suasion to steer markets away from higher inflation expectations. However, in its most recent World Economic Outlook, the International Monetary Fund cautioned central banks to be "very, very vigilant" and take early action to tighten monetary policy if price pressures persist. A tone we believed has changed slightly from earlier this year.

Only time will tell if the BOJ's MPC was proactive. According to the BOJ, their very calibrated crystal ball, which has allowed them to successfully keep inflation within the target more often than not over the last couple years, is suggesting that there is a real risk that inflation will persist, resulting in a situation where inflation remains elevated, above the BOJ's target, for a year or more. We have seen how recent increases in input costs have forced local manufacturers to increase output prices. The situation has been exacerbated by the spike in agricultural food prices owing to the negative effects of tropical storms Grace and Ida on agricultural production. As a result, inflation expectation has increased.

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The evolution and dynamics of headline consumer price inflation are heavily influenced by supply shocks, particularly those affecting food and energy prices. Although the BOJ's official metric is headline inflation, monetary policy cannot control the relative price movements caused by these shocks, nor would it be desirable for it to do so. Only when these relative price shocks have a second-round influence on the underlying trend rate of inflation – or core inflation – does monetary policy play a critical role .

When second-round effects are present or possible, a central bank's response to relative price shocks changes. As stated earlier, generally, in the absence of second-round effects and by clearly communicating the reason for its inaction, a central bank can look past transitory inflation. However, when the risk of second-round effects increases, the central bank must respond appropriately to ensure that inflation expectations remain anchored around the target, especially within the context of its single mandate.

The BOJ indicated that higher than expected pass through to local prices has resulted from the recent increase in commodity and shipping costs. These strong first-round effects may result in more broad-based price increases and consequently, lead to higher costs of living, which could raise inflation expectations and increase the pressure on households demand for higher wages. If businesses accommodate the demand for higher wages and passes on the higher labour costs to consumers by increasing the prices of goods and services, this will create second-round effects on inflation. Unless policy action is taken to manage these second-round effects, they can lead to further increases in the prices of goods and services, triggering another round of wage increases and leading to even higher inflation. The repetition of this cycle is called the wage-price spiral. If this spiral occurs, inflation could become entrenched and both difficult and costly to control and ultimately Jamaica's long-term growth could be negatively impacted.

Essentially, by stripping out the first-round effects of the increased prices, core inflation would provide an indicator of the second-round effects of increases in prices. While the BOJ did not disclose the magnitude of the increase in core inflation, it did state that it had increased. Food products make up a larger share of the "Inflation basket", especially for lower-income countries like Jamaica, hence increased commodity prices have a larger impact on the evolution of core inflation in these countries. Furthermore, because low-income families spend a larger proportion of their income on the goods in this "basket", price increases have a proportionally larger negative impact on the most vulnerable in the society. To limit the impact on this category, the BOJ intervened, as it probably should, to preserve the growth enabling macroeconomic environment over the long term and reduce the inflationary impact on, particularly, poor households.