CENTRAL BANK OF
TRINIDAD & TOBAGO

MACROECONOMIC MANAGEMENT IN A PERIOD OF UNCERTAINTY

by

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1. **It is quite clear that Trinidad and Tobago is currently experiencing a large terms-of-trade shock**—this means that the prices of our major exports (energy products) have declined markedly in relation to the prices of what we import. A clear manifestation of this situation is the accelerated downward drift in the West Texas Intermediate (WTI) global price of petroleum: WTI, which averaged US$93 per barrel in 2014, slipped to US$52 over the first three quarters of 2015, hit a low of US$26 in the first quarter of 2016 and by this week is hovering around US$47. The oil price dynamics not only reflect current and prospective developments in energy demand (slowdown in China, the switch away from fossil fuels etc.) and supply (such as Saudi Arabian reluctance to cut output, shale production in the US and Iran's entry into production for the

global market) but also a broader turnaround in the commodity cycle. The softening of commodity prices in general has wider implications for growth in many emerging and developing economies. The upshot of this state of affairs is that the price shock that Trinidad and Tobago is facing should be viewed in the international context of lingering fragility following the major 2008/09 financial crisis. Despite very low yields in industrial countries, investors have become increasingly jittery about risks in several emerging markets—since September 2015 both Moody's and Standard and Poor's have downgraded Brazil, Nigeria, Oman, Saudi Arabia, Venezuela and Gabon among other energy producers—and the pace of capital flows to such markets has substantially weakened.

2. **Compounding the energy price situation is the decline in the volume of domestic output of petroleum and natural gas**. The maturation of energy fields as well as maintenance, upgrade and infrastructural work have resulted in the following: oil and natural gas output averaged 88,262 million barrels per day (b/d) and 4,186 million cubic feet per day (mmcf/d) annually during 2010-2013; the average dropped to 81,251 b/d and 4,069 mmcf/d in 2014 and further to 78,668 b/d and 3,835 mmcf/d in 2015. Early data for 2016 show no improvement (74,710 b/d and 3,596 mmcf/d). The short term outlook is for a gradual recovery, but starting in 2017 as the results of exploration and investments emerge. Apart from the direct loss of earnings from the export of these products, the output of several other goods which rely on natural gas as an input—such as ammonia, urea and methanol—has suffered.

3. **The direct repercussions of the falls in energy prices and production are already evident in Trinidad and Tobago's balance of payments and Government revenue**. According to rough estimates by the Central Bank, over the period 2010-2015, every US$1 change in the price of oil affected export values by about US$50 million. Government revenue is also closely aligned to international oil prices—in particular the Supplemental Petroleum Tax only kicks in when oil prices are at or exceed US$50 per barrel. Of course, when we add the decline in the price and volume of natural gas, the situation is exacerbated, particularly as much of the Government's revenue currently comes from natural gas. Over the 1990s petroleum taxes contributed the bulk of energy revenue, eventually giving way to the tax take from natural gas, which in recent years formed the base for around two-thirds of energy revenue.

4. **Spillover effects have also been evident in overall economic growth and to a more limited extent in the unemployment numbers.** Real GDP is estimated to have contracted by 2.0 per cent in 2015, and there is broad consensus that—given the output by major energy companies so far in 2016, their plans for the rest of the year, and the sluggishness in the non-oil sectors—a recovery this year is hardly on the cards. Latest 2016 growth estimates from the Central Bank, the International Monetary Fund (IMF) and rating agencies Moody's and Standard and Poor's (S&P) all hover around -2.0 to -2 ½ per cent. [1] There has also been some labor shedding in energy service companies and a few manufacturing firms although the official overall unemployment rate has moved marginally from 3.3 per cent at the end of 2014 to 3.5 per cent during the fourth quarter of 2015.

5. **While the order of magnitude of the shock and the immediate impacts are fairly well known, there is a large degree of uncertainty as to how long the situation will persist.** As an energy producer, Trinidad and Tobago has been here before, with the vicissitudes of oil and gas prices often calling the economic beat. Two of the starkest episodes of energy price surges were in 1973/82 and 2002/08, and of price falls were 1985/88 and 2008/09. Not only was the duration of each episode different, but for the most part there was little clue while they were happening as to how long each would last. The current situation is also characterized by uncertainty. In late 2013, with oil prices fluctuating around the US$100 per barrel mark, few forecasters would have predicted a plunge to US$30 and below several months later. A scan of price forecasts this week show the variation—the IMF forecasts Brent crude prices from 2016/20 in the US$36-$50 range; Bloomberg's predictions range from US$40-$60, while Business Monitor International's estimates are between US$40 and US$71. A year ago these institutions' forecasts for 2016-20 were between US$60 and US$90. On the local energy production side there does however seem to be greater consensus on the short term outlook, involving a dip in output in 2016 followed by a gradual recovery over the next few years.

[1] Central Bank of Trinidad and Tobago, *Economic Bulletin*, March 2016, Moody's press release April 15, 2016, S&P press release April 22, 2016. The IMF's projection of -1.0 per cent in the press release of March 17, 2016 was revised to -2.7 per cent in May 2016.

6. **It is within this context of uncertainty that macroeconomic policies must be developed and coordinated.** Given the characteristics of Trinidad and Tobago, the key macroeconomic components are fiscal, structural and monetary policies. With a still dominant state sector, a sharp decline in energy revenue is felt widely—from the direct results of attendant pullback in spending on transfers or capital projects through to the influence on local capital markets via government borrowing. Structural policies or reforms, often overlooked when an economic shock is short-lived, must take center stage over a longer time horizon, especially to facilitate a greater role for the private sector once the government's role is constrained over time. Finally, monetary policy would be available to influence credit conditions to facilitate an eventual recovery, while avoiding overheating and inflationary pressures which could erode the external value and purchasing power of the domestic currency. But policies in these three areas must be well coordinated to increase the chances of success (barring a recovery in energy prices and output). So how is all of this to be achieved in an environment characterized by uncertainty? While there are no foolproof answers, there are a few guidelines that can help to shape the approach to macroeconomic policy setting.

7. **First of all, it would be prudent to treat the shock as permanent.** Unlike some other countries, Trinidad and Tobago is currently in the relatively fortunate position of having at hand some buffers—shock absorbers if you will—to deal with the economic situation. A starting point of relatively low debt by international standards, a large stock of official foreign exchange reserves and savings in a Heritage and Stabilization Fund offers some measure of control in the pace of adjustment. Of course, one must be careful that the availability of these buffers does not result in the depth of the problem being unrecognized, ignored or not well communicated, or that the needed adjustments are not taken at all or are unduly delayed. So, when and at what pace should these buffers be used? Naturally, the answer depends on the circumstances. For example, let's consider a person who has built up savings over the years—a bit of cash, savings and time deposits, maybe some shares etc.—and has lost his job. His approach to utilizing his savings would differ depending on if: i) he knows that another job is just around the corner; or b) he needs to go to school for a year to be retrained for a fresh job; or c) he had suffered a permanent disability that took him off the job market completely. Taking things to the macroeconomic level, and adding uncertainty to the picture the analysis and possibilities could become even

more complex. But action does need to take place and I would suggest that the best approach is to consider the shock as long-lasting and utilize the country's available buffers at a measured pace while making other more fundamental adjustments.

8. **The fiscal response should balance carefully the need for expenditure restraint with the longer term growth objective.** The early adjustment path in Trinidad and Tobago has seen a recalibration of Central Government revenue to take account of lower global energy prices—the FY2014/15 budget was built on an oil price of US$80 per barrel and at midyear the price projection was revised to US$45; in FY2015/16 the initial estimate was US$45, subsequently lowered to US$35. Natural gas price estimates were similarly recalibrated. In each case, expenditure plans were also adjusted but not enough to prevent overall fiscal deficits. Consistency with the perspective of treating the energy price/production drop as long-lasting implies that durable measures need to be assessed and put in place on the expenditure side (and also on the non-energy revenue side) to forestall an eventual buildup of debt. Difficult choices will likely have to be made, especially with respect to the components of recurrent expenditure, in the search for a sustainable solution. At the same time, it is likely that there could be considerable scope for strengthening public sector management to reduce waste, bolster efficiency, and beef up tax collection—one practical and early avenue for improvement is the sharpening of debt management to reduce interest costs to the state, which for the Central Government stood at about 8 per cent of non-oil revenue in FY2015/16.

9. **The opportunity should be taken to advance institutional reforms that may have been delayed when oil prices were buoyant**. The institutional framework for public and private sector activity—legislation, setup and modus operandi of bureaucracies, operating standards and procedures, accountabilities for service delivery, harmonization across agencies, level and enforcement of penalties etc.—requires constant review as an economy evolves. Factors such as the emergence of new products, new businesses, heightened international competition, advances in technology and revved up speeds of communication mean that the framework must evolve quickly. However, when an economy is doing well inefficiencies are often masked, standards may slip and the requisite changes not put in place. The economic challenge currently confronting Trinidad and Tobago offers an opportunity for a wholesale assessment aimed at

streamlining and modernizing this institutional apparatus. The 'trade facilitation' initiative that is underway (involving the Ministry of Trade, Customs and Excise Department, the Manufacturers' Association, Chamber of Commerce and other agencies) to assess and coordinate the requirements/procedures for trade and investment is a great example of what can be put in train. While such reform programs need careful planning and execution in a sequenced fashion for them to be sustainable, a lot can be achieved in the short run with concerted communication and effort from the public and private sector bodies involved.

10. **Monetary policy should be responsive to the dynamics of adjustments across the economy.** Broadly speaking, the primary aim of monetary policy in Trinidad and Tobago is to foster conditions in the financial system conducive to low and stable inflation, which impacts the purchasing power of the local currency. As a corollary of this, the Central Bank has an important role in the foreign exchange market particularly as, as banker to the Government, it converts much of the energy taxes that the latter receives in foreign currency into domestic currency. In fact, during the current adjustment period the foreign exchange market has been one of the first markets 'out of the blocks', as it were, for two main reasons: First, as noted earlier, the drop in international energy prices affected Government revenue and the balance of payments directly—depressing both the growth of official international reserves held at the Central Bank (as less Government energy taxes were converted) and the foreign exchange conversions by energy companies in local financial institutions. Second, financial transactions, including those involving foreign exchange, take place very quickly in the context of modern communications technology and Trinidad and Tobago's open external current and capital accounts. Comparatively however, the responses in other markets are not as instantaneous: for example, the Government revisited its original 2015/16 budget after six months and as the unemployment numbers suggest, the adjustments in the labor market may still be at an early stage.

11. **In this setting, the Central Bank's perspective is to look at the longer-term horizon and react as if the shock were permanent.** This approach has the benefit of preparing for the worst, while we can easily accommodate the upside if energy prices recover. Our analysis of the lags in the pace of adjustments in the rest of the economy leads us to the conclusion that monetary and foreign exchange policies would likely not be able to address all short run

disequilibria. Specifically, the impacts of planned cuts in Government expenditure will take at least several months, businesses and individuals will take some time to adjust their spending and investment patterns, and the recent currency depreciation will affect import demand with a lag—particularly after imported stocks are depleted. Moreover, expectations by analysts, investors and the general public will likely be in a state of flux as they come to terms with the economic situation and assess the macroeconomic response. Within this environment, the Central Bank's monetary stance will continue to be flexible, managing domestic liquidity and influencing interest rates, in order to keep inflation at reasonable levels and fostering stability in the financial system that would be conducive to growth. In the foreign exchange market, we similarly take the long view, assessing our international reserve adequacy and intervention programs (how much foreign exchange we buy and sell) over a 2 to 3 year horizon. While we do not target a specific nominal exchange rate, we do aim to limit exchange rate volatility (wild swings in the rate). Operationally, we currently intervene at least on a bi-weekly basis, with the volume of foreign exchange sales (or purchases) determined by estimates of current and prospective foreign exchange flows. With the Bank's longer run view we accept that in the short run each intervention may not result in complete balance between forex supply and forex demand—some of which would be precautionary in nature during this economic adjustment period.

12. **Ultimately, macro policies must be aimed at supporting a larger role for the private sector and businesses should gear up to fill this role**. As the Government rationalizes its functions in the context of lower tax revenue, opportunities open up for non-public sector entities. Competition will be stepped up as consumers demand better service and shop around more for greater value and cheaper options—we have already seen how some 2016 Carnival fetes were cancelled as partygoers calculated which activities they would retain on a more limited entertainment budget. This approach to more careful spending is likely to continue more broadly and businesses will be forced to sharpen their service and work more diligently to remain profitable. One benefit of this set of dynamics is that the firms that hone their skills and thrive in this tougher environment would be much better placed to deal with international competition. In this regard, measures already being taken by some business organizations to extend deeper into CARICOM markets and wider towards Latin America and further abroad are steps in the right direction. Such efforts have been in the works for some time, and in the present

circumstances a redoubling of energies in a coordinated fashion could lead to substantial dividends.

13. **Uncertainty does not provide an excuse for policy inertia; macroeconomic actions should be built on the information available with a view to addressing long term priorities.** Trinidad and Tobago's current economic problems are not new, nor are they unique to this country. But because no one knows exactly how long this shock will last, the prudent stance of macro policies should be to develop strategies and action plans as if it were permanent. The three stands of policy—on the fiscal, structural, and monetary sides—need to be coordinated and the private sector should prepare to assume a larger role. Important lessons from our own earlier boom-bust experiences as well as the experiences of other countries should be frontally brought to bear on the analytics and the action plan. And once this is over, we should catalogue and save the lessons from this episode in readiness for future shocks.

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