

Feature Address

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^{*}Information related to individuals and companies has been removed from the original text (December 30, 2015).

Ladies and Gentlemen,

I thank the Downtown Owners and Merchants Association for graciously agreeing to cohost, with Central Bank, the Fifth Monetary Policy Forum.

This Forum received praise recently from a media house as a good communication channel I introduced. Considering how hard it is to get praises these days as a central banker, well I will take that praise, and say yes...this Monetary Policy Forum is important. It's important for Central Bank...and for you the business community to understand and learn from us first hand why we do what we do. Well at least I got one thing right!

With a stingy supply of praise for central bankers these days, when I leave office in 19 months when my legally established 5-year term as Governor comes to an end, I expect the things I did get right (yes there was more than one!) will scarcely be mentioned, and that's fine with me. Central bankers function in a world where it is damned if you do and double damned if you don't.

There are a few other Central Bank Governors with whom I can identify, as one minute they are praised and then the next they are not doing enough at the pace everyone else thinks they should be working. Mark Carney, Governor of the Bank of England, and former Governor of the Bank of Canada hailed as the "outstanding central banker of his generation"... was recently called an "unreliable boyfriend" after nearly two and half years into his five year term for his "one day hot, one day cold" messages to the financial markets on when the Bank of England is likely to raise interest rates in the UK.

Chair of the US Federal Reserve, Janet Yellen, has also been facing her share of criticism for her timing of kick starting the inevitable end of the US zero interest rate policy. Too early...too late. Like Carney and Yellen I can

relate to how easy the public expresses its views on these complex decisions. Their comment on these matters is where many are misled into believing there is ease and simplicity associated with central banking. No decision taken by a central banker is easy or simple. Maybe this will become clearer to you this morning, as I explore two cases of damned if you do and double damned if you don't...monetary policy and interest rates and...foreign exchange, as I speak to the brutal economic realities facing us.

RECENT ECONOMIC DEVELOPMENTS

Since the release of our previous Monetary Policy Report in early June 2015, Trinidad and Tobago's economic growth prospects remain subdued amid weak business and consumer confidence. Following a dismal first half of 2015, domestic economic activity was depressed in the third quarter of 2015. Similar weak economic conditions have prevailed so far into the fourth quarter of 2015.

Four consecutive quarters of decline in real GDP in 2015 means Trinidad and Tobago is now officially in a recession.

What brought on this 2015 recession, which should not come as a major surprise to many of us? Well... prolonged supply disruptions in the energy sector in 2015 continued to result in sharp shortfalls of natural gas production which, in turn, adversely affected output of LNG and petrochemicals (methanol, ammonia, urea and iron and steel). Lower energy prices also negatively impacted the domestic energy sector. This has already been reflected in job losses at some energy companies. The decision by Arcelor Mittal to idle its steel plant will not only affect energy output but also jobs.

The non-energy sector, which has kept the economy from veering off its already weak growth trajectory for the past few years, seems to have lost its momentum. Weakness has crept into key sectors such as distribution and construction, following a temporary pick-up

in non-energy activity driven by spending in the run-up to the General Elections. The latest Business Confidence Survey suggests optimism waned among the local business community in the third quarter of 2015.

On this basis, Central Bank estimates the Trinidad and Tobago economy is likely to contract by $1\frac{1}{2}$ percent in 2015, a reversal of the sluggish but still fairly decent growth of around 1 percent in 2014. We expect the energy sector to contract by just over $3\frac{1}{2}$ percent, while activity in the non-energy sector is expected to be flat in 2015.

I've said it, the "R" word, recession. It's not the kind of news you want to deliver to the country 21 days before Christmas. However, the economic events over the past year should have started sobering, even the most financially nonchalant among us.

The last time the country saw economic performance figures like these was in 2009, a recession which lasted all of one year. Prior to that, the country experienced a severe recession for seven consecutive years from 1983 to 1989.

This brings me to the Central Bank's proactive monetary policy stance; a clear example of damned if you do, double damned if you don't.

We always have to consider whether to act early or act later. Since September 2014, we started gradually increasing our policy interest rate. We believe we must act well in advance and as much as possible to help insulate the Trinidad and Tobago economy from the potential disruptive shocks we are expected to feel from rising U.S. interest rates. Close linkages with the United States expose Trinidad and Tobago to fluctuations in U.S. economic activity and changes in U.S. monetary conditions.

At its December 2015 meeting, Central Bank's Monetary Policy Committee (MPC) agreed to raise the 'Repo' rate by 25 basis points to 4 ¾ percent. Although this was the eighth consecutive hike in the Repo rate, the MPC still views the monetary policy stance to be accommodative. In fact, we are still far from reaching the neutral policy rate, which is considered neither too restrictive, nor too accommodative.

As you've heard us say in the last year since we started raising interest rates, the most influential decision driving Central Bank's monetary policy stance is the forthcoming normalization of U.S. monetary policy. The US Federal Reserve has delayed the long-awaited increase in its policy interest rate, waiting until the U.S. labor market shows continued strength accompanied by firm signs inflation is rising towards its medium term target. While there is still the possibility for the Fed's first rate increase since June 2006 to occur before the end of 2015, market opinion remains somewhat divided on its exact timing.

The Fed's interest rate lift-off could lead to bouts of market turbulence and reversals of capital flow in emerging economies, at a time when global financial markets are already volatile owing to uncertainty over China's growth prospects and falling commodity prices.

The continuing challenge for monetary policy is to achieve a fine balance, let me stress, an extremely fine balance between insulating the Trinidad and Tobago economy from external shocks and not unduly undermining short term growth. The MPC considered delaying further increases to interest rates. This could give the Monetary Policy Committee room to re- assess unfolding developments and avoid choking off a possible recovery in the non-energy sector. On the other hand, the MPC was of the opinion that delaying further increases to interest rates would require an even stronger monetary policy response in the future, with more severe consequences for short-term growth in the non-energy sector. In other words, move interest rates slow and steady, instead of a big bang.

Think about it, when we started moving interest rates last September, we were at 3 percent. What if we didn't move then? In order to protect us now, we would have to raise interest rates by at least 100 basis points. Let's say the Fed announces its rate increase in mid-December at its last meeting of the year, our MPC meets every two months and our next meeting would be at the end of January, two months after the Fed's hike, and all the financial markets have reacted. We would be caught playing serious catch up. Since our rate hikes take about six months to start working its way through the banking system, that means we could have been facing almost a 9-month lag between our increase and the Fed's.

There have been those who have not agreed with the Central Bank's position, a difference of opinion is healthy, but I say to those sitting on the sidelines, don't be so quick to judge, damning us for our proactive monetary policy. Central banking is like perfectly balancing an orange on a pin's head. It's not impossible, just nearly. We of all people understand the implications of our decisions and what's at stake. We are not nonchalant with our country's economy.

Recent statements by the Fed's Chairwoman Janet Yellen hinted about the "live possibility" the Fed would hike interest rates in the next two weeks at its December 15-16th meeting. Regardless of the exact timing, the Fed's path towards normalization of U.S. monetary policy is imminent. Whether the Fed raises rates next week or early next year, it will become the first central bank among the advanced economies to start the process of tightening monetary policy at a time when the European Central Bank, the Bank of Japan and other major central banks are easing monetary conditions.

The central banks in Brazil, Colombia, Peru, Chile and South Africa have already begun to tighten their monetary policy in order to address the possible threats stemming from the Fed's imminent move to increase interest rates, and as I've explained Central Bank of Trinidad and Tobago has been taking the same action.

For Trinidad and Tobago, the timing and pace of increases in U.S. interest rates have tremendous implications for portfolio capital outflows and foreign exchange demand, especially since returns on U.S. dollar assets remain more attractive than TT dollar assets. Higher domestic interest rates are necessary to enhance returns on TT\$-denominated assets, helping to curb portfolio capital movements out of Trinidad and Tobago. Higher domestic interest rates are also necessary to discourage heavy consumer borrowing on imported consumer durables which are a major source of foreign exchange demand. Higher interest rates are even more important to provide a lifeline to private pension funds and insurance companies whose investment portfolios have been under tremendous stress in the prolonged low interest rate environment.

In making its interest rate decision, the MPC was also concerned about rising inflationary pressures into early 2016 due to fiscal measures announced in the 2015/2016 Budget.

Despite some volatility in food inflation, headline inflation has been relatively moderate to date, slowing to about $3\frac{1}{2}$ percent in October 2015. After being subdued at about 2 percent over the first nine months of 2015, core inflation – a measure of underlying price pressures – accelerated to nearly $2\frac{1}{2}$ percent in October 2015, partly reflecting the 15 percent increase in the price of diesel and super gasoline announced in the 2015/2016 Budget.

If VAT is introduced at 12½ percent on all previously VAT-exempt items, most of which form part of the food basket, Central Bank estimates this could push core inflation to almost 3½ percent and food inflation into double digit territory. As result, headline inflation could pick back up to around 5 percent.

Short-Term Prospects

The grim reality is Trinidad and Tobago is in a recession, stuck in a low- growth cycle, vulnerable to further declines in energy prices and production. Central Bank's short term outlook for 2016 is for:

- 1. Continued contraction of the Trinidad and Tobago economy, on the back of a further decline in the energy sector, which will compound sluggishness of the non-energy sector;
- 2. The country's external position to come under more pressure;
- 3. Central Government's fiscal deficit to increase from what was budgeted; and
- 4. Public debt to rise as a result of more government borrowing to finance projects.

I'll explain the thinking behind our outlook. Real GDP is expected to contract by 1 ½ percent in 2016, as the energy sector continues to grapple with natural gas shortfalls and low oil and gas prices. We do not expect all three wells from BGTT's Starfish gas field to be fully operational in 2016. Production from BP's Juniper field is not expected to come on stream until 2017.

The recession will start setting in come 2016, and while many may not have felt or seen any effects of the decline this year, as 2016 progresses there will be noticeable signs as businesses hold back on investments, consumers cut back on spending and fewer loans are taken out. A lower capital expenditure program will hit the construction industry, as

well as a more lasting reduction in steel production by Arcelor Mittal. Depressed construction activity will temper cement production.

The country' gross official reserves are projected to fall again as energy exports decline further, but will still continue to exceed conventional benchmarks of reserve adequacy (such as import cover and short term debt coverage). The anticipated drop in reserves will translate into less foreign exchange available to Central Bank to support the market. Energy exports are expected to decline by around US\$600 million, constraining foreign exchange inflows. Central Bank will provide a pre-announced schedule of its foreign exchange interventions to commercial banks to maintain stability in the market.

Central Government's fiscal deficit is projected to reach about \$7 billion. This is higher than the budgeted \$3 million deficit for FY2016 and must be financed by greater borrowing. Non-energy revenues are overly ambitious,

budgeted at a little over \$40½ billion, the highest level ever. However, over half of these non-energy revenues- \$26 billion- are coming from just two limited sources.

The first source sees Government broadening the VAT base through the removal of extensive exemptions and zero-rated items. But the VAT revenue target of 12½ billion is too optimistic since it requires the BIR to significantly ramp up compliance and enforcement, a process which takes a few years. We project Government will realistically collect around \$8½ billion, or two-thirds of its anticipated VAT receipts. Implementation of several other fiscal measures requires legislative changes, which are unlikely to take place within the fiscal year, and could worsen the already delicate revenue position.

The second source is a heavy reliance on large extraordinary non-energy revenue inflows of almost \$13½ billion, which will be realized but will not be repeated to support future spending. These inflows include continued dependence on dividends from the National Gas

Company (NGC), which could further undermine the company's weakened financial performance.

Government is yet to announce a specific set of policies to return the fiscal framework to a sustainable path. On current policies, the fiscal balance and debt ratios would continue to worsen over time, reinforcing the urgent need for fiscal adjustment.

Developments in the Foreign Exchange Market

Let me now turn to the foreign exchange market, which is another example of damned if you do, and double damned if you don't.

The foreign exchange market has always experienced imbalances. These imbalances arise because foreign exchange supplies are irregular and enter the market at discrete intervals but demand is always high and continuous throughout the year. Central Bank steps in and sells foreign exchange to the banking system from its stock of official reserves to offset the shortfall. These sales are carried out through the Central Bank's foreign exchange distribution system using financial institutions which are licensed as authorized dealers.

Let me emphasize the number of financial institutions licensed by the Central Bank as authorized dealers has not changed since 2007 when Bank of Baroda became the country's twelfth authorized dealer. In 2012, when I assumed office there were 12 authorized dealers. In 2013, there were 12 authorized dealers, as in 2014. In 2015, the number of authorized dealers remains at 12.

On October 29th 2015, after consultations with and acting on directives from the Minister of Finance...Central Bank fully re-introduced the "old" foreign exchange distribution system

which was operating up to the end of March 2014. This "old" system replaced the "new" one which was in place during April 2014 to October 28th 2015. So, what was the fundamental difference between the two systems?

Well, under the system that was in place for 19 months from April 1 2014 to October 2015, the eight commercial banks who are authorized dealers received 95 percent of the foreign exchange sold by Central Bank, while all four non-bank financial institutions who are also authorized dealers got the remaining 5 percent of our foreign exchange sales.

Two of these non-banks – Ansa Finance and Merchant Bank and Massy Finance GFC - are affiliated to two of the country's largest conglomerates. These two conglomerates have a combined annual foreign exchange market demand of at least US\$ 500 billion.

Each authorized dealer receives its share of foreign exchange from the Central Bank on the basis of its share of the foreign exchange market. It is now public knowledge, the biggest share of foreign exchange was and is still allocated to Republic Bank Limited, the country's largest bank. RBL saw its share of foreign exchange fall from $27\frac{1}{2}$ percent in March 2014 under the "old" system to 25 percent in April 2014 under the "new" system, as part of its share was reallocated to Scotia, Citi and First Citizens whose shares of the foreign exchange market had grown over the years.

Under the "old" system we reintroduced at the end of October 2015, the eight commercial banks receive 95¼ percent of our foreign exchange sales, while only two of the four non-banks – Ansa Finance Merchant Bank and NCB Global Finance - get the remaining 4¾ percent of our foreign exchange interventions.

We did not revoke the licenses of Massy Finance GFC and Development Finance Limited, the two non-banks that were taken out of the foreign exchange distribution system. There is no legal or regulatory basis for such action. These two non-banks are simply not allowed to participate in Central Bank's foreign exchange distribution system now, and was the case before April 1, 2014.

There has been unnecessary anxiety that the US\$500 million was entirely used up in a few days. Central Bank expected this intervention to be devoured. The US\$500 million was intended to eliminate the existing backlog in foreign exchange demand. Some of that demand involved payments to existing creditors for goods already purchased.

The message of the US\$500 million record sale is this... the insatiable demand for US dollars that exists in Trinidad and Tobago, will always trump whatever distribution system is in place. Because it is the commercial banks not the Central Bank that determines who gets foreign exchange, when they get and how much they get.

We must wake up to the sobering reality - we are in an extended period of low energy prices and falling energy production. This means energy exports are falling. In 2013, energy exports stood at nearly US\$11 billion. This fell to about US\$10 billion in 2014. In 2015, we estimate energy exports to fall even further to US\$7 billion.

Falling energy exports have slowed conversions of US dollars by energy companies, the main source of inflows to the domestic foreign exchange market. In 2013, conversions of US dollars by energy companies amounted to US\$4 billion. Conversions fell to US\$3.7 billion in 2014. In the eleven months to November 2015, conversions from the energy sector stood at around US\$3 billion, 25 percent lower than in 2013.

As a result total inflows of foreign exchange have been falling over the past three years. In 2013, the total supply of foreign exchange stood at US\$5.8 billion. In 2014, it fell to US\$5.5 billion. In the first eleven months of 2015, total inflows of foreign exchange fell by almost 20percent to US\$4.4 billion. On the other hand, domestic appetite for foreign exchange remains robust. In 2013, the demand for foreign exchange stood at US\$7 billion, about the

same as in 2014. During the first eleven months of 2015, demand for foreign exchange amounted to US\$6.8 billion.

In the month since Central Bank made its US\$500 intervention, I've been asked about 500 million times, where has all that money gone. Here's the answer.

The retail and distribution sector is the most voracious consumer of foreign exchange. It swallowed almost US\$4½ billion or nearly 1/3 of the total foreign exchange sold over the past three years. Five companies alone accounted for over US\$1 billion of the total foreign exchange sales to the retail and distribution sector.

The manufacturing sector is the second largest consumer of foreign exchange, using close to US\$2 billion in 2013-2015, or just under 15 percent of total supply.

Let's go to another compulsive user of foreign exchange, and I'll take the credit for making this user popular during my December 2014 Monetary Policy Forum speech. Who remembers credit card payments? Commercial banks must make payments to the Visa and MasterCard before satisfying any other source of foreign exchange demand. Credit card payments consumed about US\$1.8 billion or 13 percent of total foreign exchange supply in the last three years.

Car dealerships are the fourth largest user of foreign exchange. They used US\$1.3 billion or just under 10 percent of total foreign exchange supply over the past three years.

The telecommunications sector is the fifth largest consumer of foreign exchange. It used up close to US\$900 million in 2013-2015.

Together, these five sectors ate up US\$10½ billion or more than 70 percent of all foreign exchange sold in the past three years. Individuals used up another US\$525 million over the past three years, mainly for travel and to pay overseas tuition fees and educational expenses.

The combination of lower supply and robust demand resulted in a widening of the foreign exchange gap. In 2013, the foreign exchange shortfall amounted to US\$1.2 billion. The foreign exchange gap widened to US\$1.4 billion in 2014. Over the first eleven months of 2015, the foreign exchange shortfall expanded substantially to US\$2.4 billion.

In keeping with its long-standing foreign exchange policy, the Central Bank provides the shortfall to the market selling foreign exchange to the banking system from the country's stock of official reserves. Central Bank does not (I repeat, Central Bank does not) supply the entire market with foreign exchange, as seems to be the widely-held belief.

In 2013, Central Bank sold US\$1.3 billion to the domestic foreign exchange market. This accounted for about 18 percent of total market supply. In 2014, we sold US\$1.4 billion, which accounted for around 25 percent of supply. In 2015, Central Bank sold just under US\$2.5 billion to authorized dealers – the highest level of foreign exchange intervention on record. Our most recent sale was US\$50 million on November 30th.

Allow me to put Central Bank's sales in a regional context, just so we get a basic appreciation of the harsh realities around us.

Dominica is drawing down about US\$8.7 million from the IMF's Rapid Credit Facility to support recovery efforts in the wake of Tropical Storm Erika. We sold foreign exchange equivalent to Dominica's drawdown under the IMF's facility within one trading week

Grenada has a three-year program with the IMF worth US\$21.7 million. Grenada just received approval for an additional disbursement after completing a debt restructuring agreement with the Paris Club creditors. We sold foreign exchange equivalent to total funding under Grenada's three-year IMF program in just two trading weeks.

Jamaica has a four-year Extended Fund Facility program with the IMF worth US\$932 million. The conditionalities call for ambitious fiscal consolidation, improvement in competitiveness, debt reduction, and improved social protection. We sold foreign exchange equivalent to the entire funding under Jamaica's four-year IMF program in the first six months of 2015.

I can almost hear some saying this is like comparing apples and oranges, of course I know we are not the same as these Caribbean neighbours in terms of size of economy, financial development and resources. However I draw these cases to your attention, to inject some realistic appreciation of how good we have it now.

I've been double damned for the foreign exchange policy in effect for the last 19 months. When I leave office in 19 months, the one thing I know you will remember me for, is making you more aware of how we use the country's precious foreign exchange reserves and what we use it for. The irony is, the system that I implemented, while I was damned for it, was done to allow the already limited share of foreign exchange to reach more businesses directly, instead having conglomerates jostle with other businesses at the commercial banks for foreign exchange. It gets even more ironic that on a few occasions those very conglomerates complained bitterly in public they weren't getting enough foreign exchange, as I said damned if you do, damned if you don't.

As is always the case in this country, we belabor the symptoms and neglect the disease. Defining the shortage of US dollars as a Central Bank problem is a convenient but wholly incorrect narrative. Central Bank alone does not have the long term solution to our foreign exchange problem. The current shortage of US dollars will not be solved unless we

dramatically change our consumer-driven, heavily import-dependent behavior. The import content of our consumer spending is at least 80 percent. Look at our exuberant behavior during Black Friday, just one week ago, with shoppers camping outside the doors of wholesalers waiting eagerly to pounce on that must-have imported US\$400 JVC 43-inch television.

The current shortage of US dollars will not be solved until we become serious and stop paying lip service to diversification. We have been grappling with the conundrum of diversification for many years, with few tangible results other than the successful move into the downstream energy sector. Diversification beyond the energy sector must focus on export sectors where there we have a competitive advantage (we have something to sell that the world wants) and where there is good growth potential.

Conclusion

Trinidad and Tobago is facing austere economic circumstances. The economic priorities in 2016 must be aimed at supporting a firm enough recovery through appropriate monetary and fiscal policies, setting forth a medium-term framework which balances consuming, saving and investing energy wealth.

The appropriate monetary and fiscal policies can only come from the Central Bank and the Ministry of Finance working together. We have no choice, we can and should work together to ensure we get the policies right for the country's recovery.

We will all be doubled damned if spite, vindictiveness and ego keep us from working together to help our country.

I thank you.