CENTRAL BANK OF TRINIDAD & TOBAGO

# "Review of the Economy 2005, Short-Term Prospects and Challenges"

## Address
**at**

## Trinidad and Tobago Petroleum Conference 2006

by

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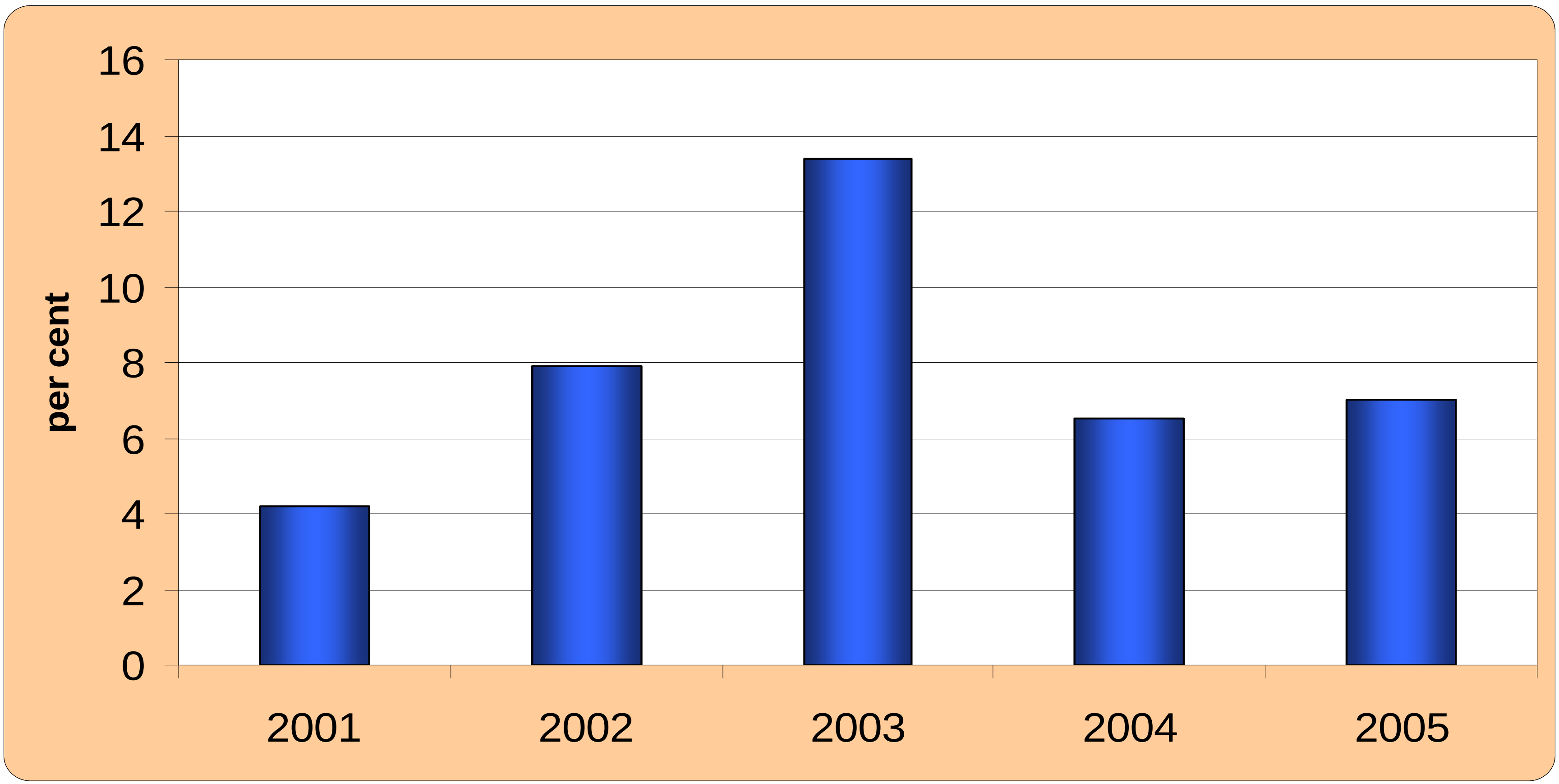
*February 06, 2006*

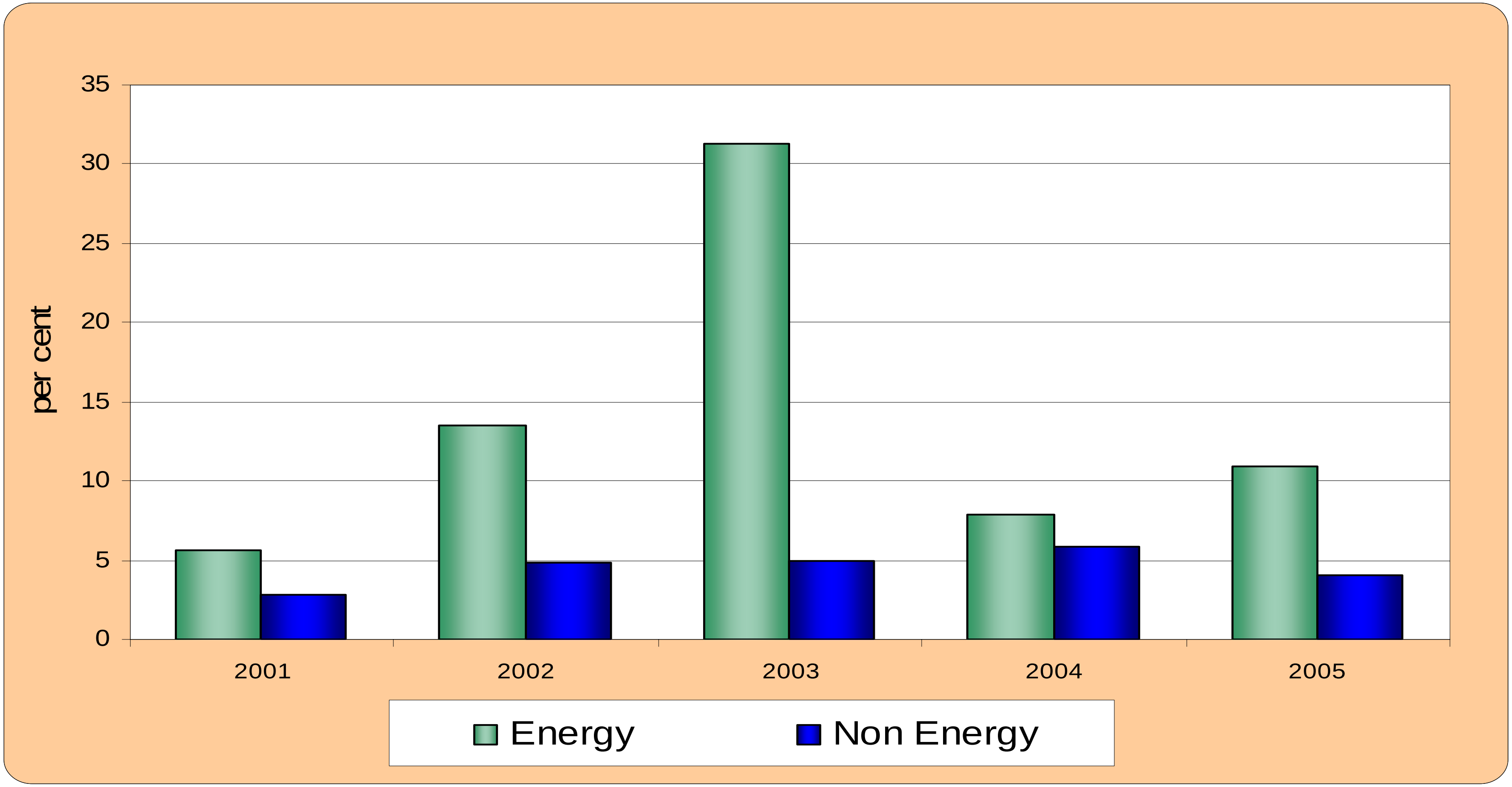
# Chart 1
# Growth in Real GDP




**Source: Central Statistical Office**

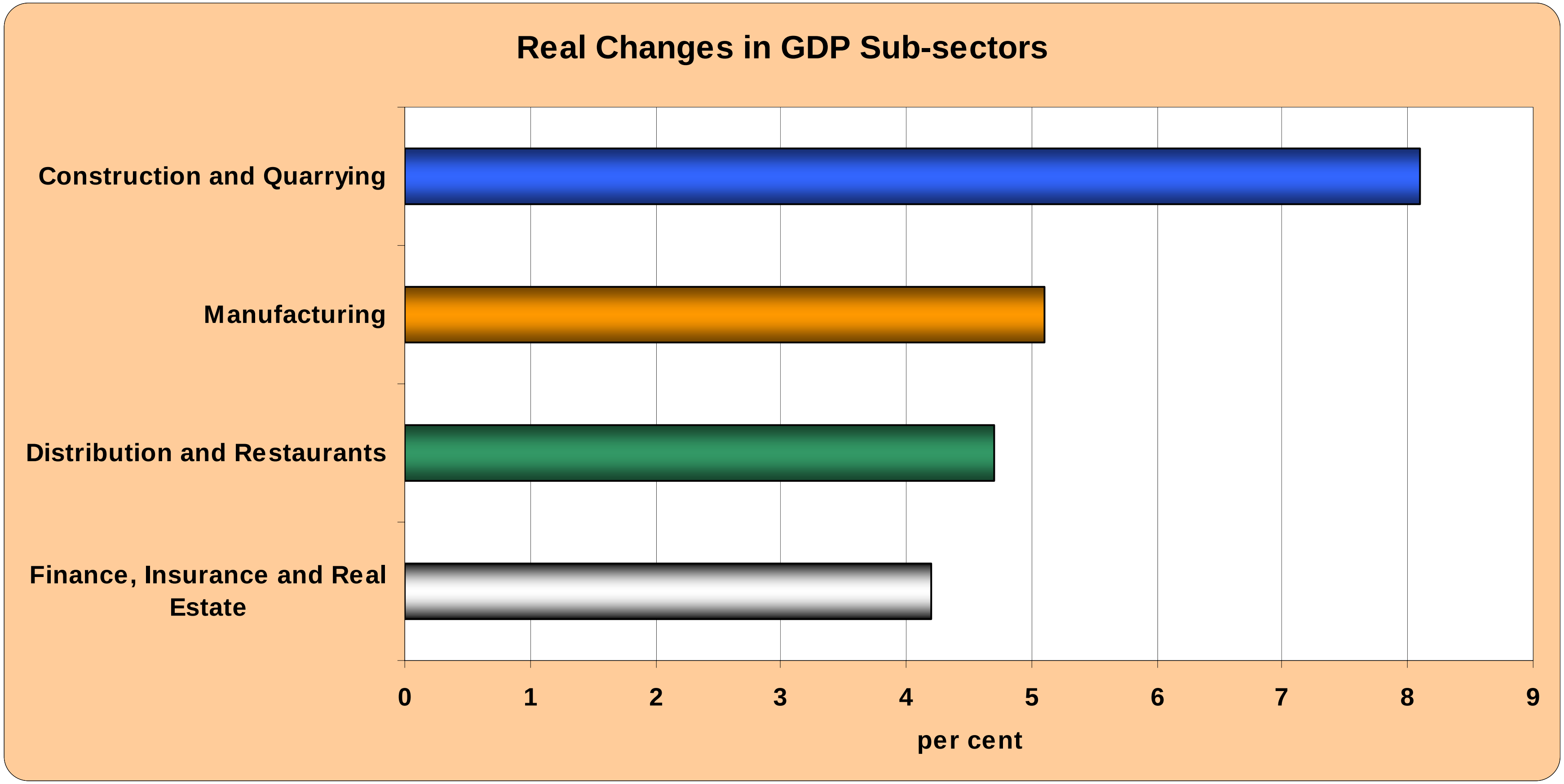
# Chart 2

## Growth in the Energy and Non Energy Sectors



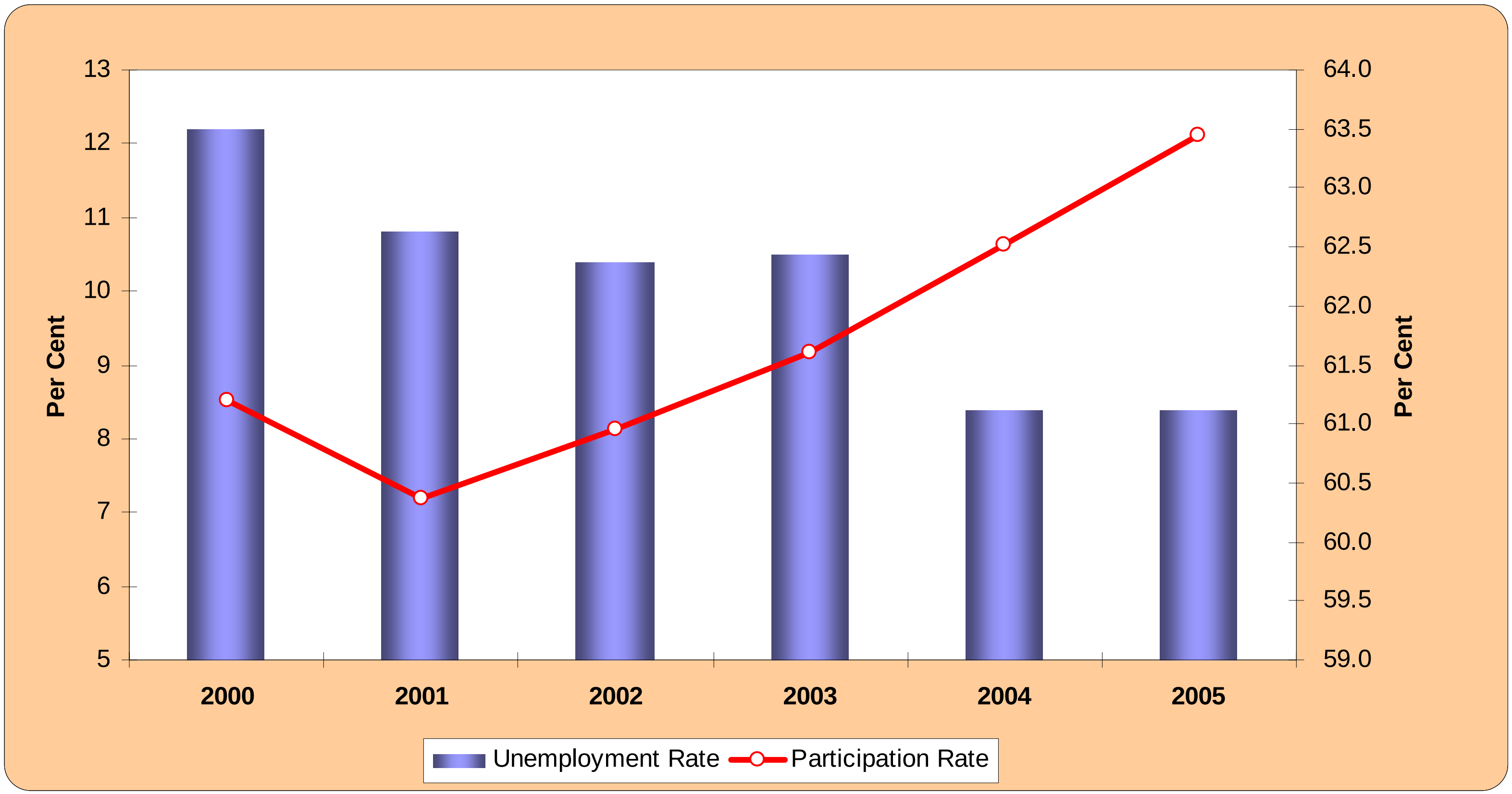

**Source: Central Statistical Office**

# Chart 3
# GDP Growth in Selected Sub-sectors 2005



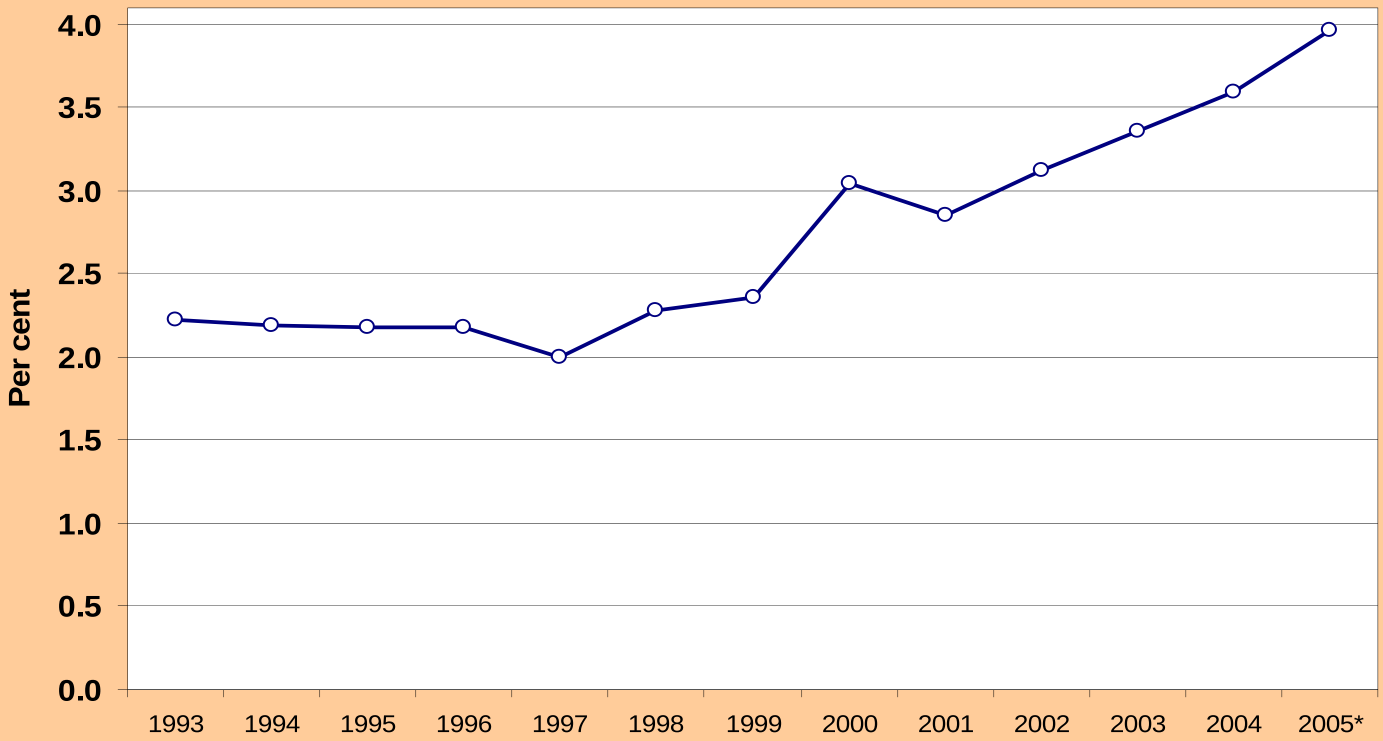

Source: Central Bank Estimates

# Chart 4
# Unemployment and Labour Force Participation Rates




**Source: Central Statistical Office**

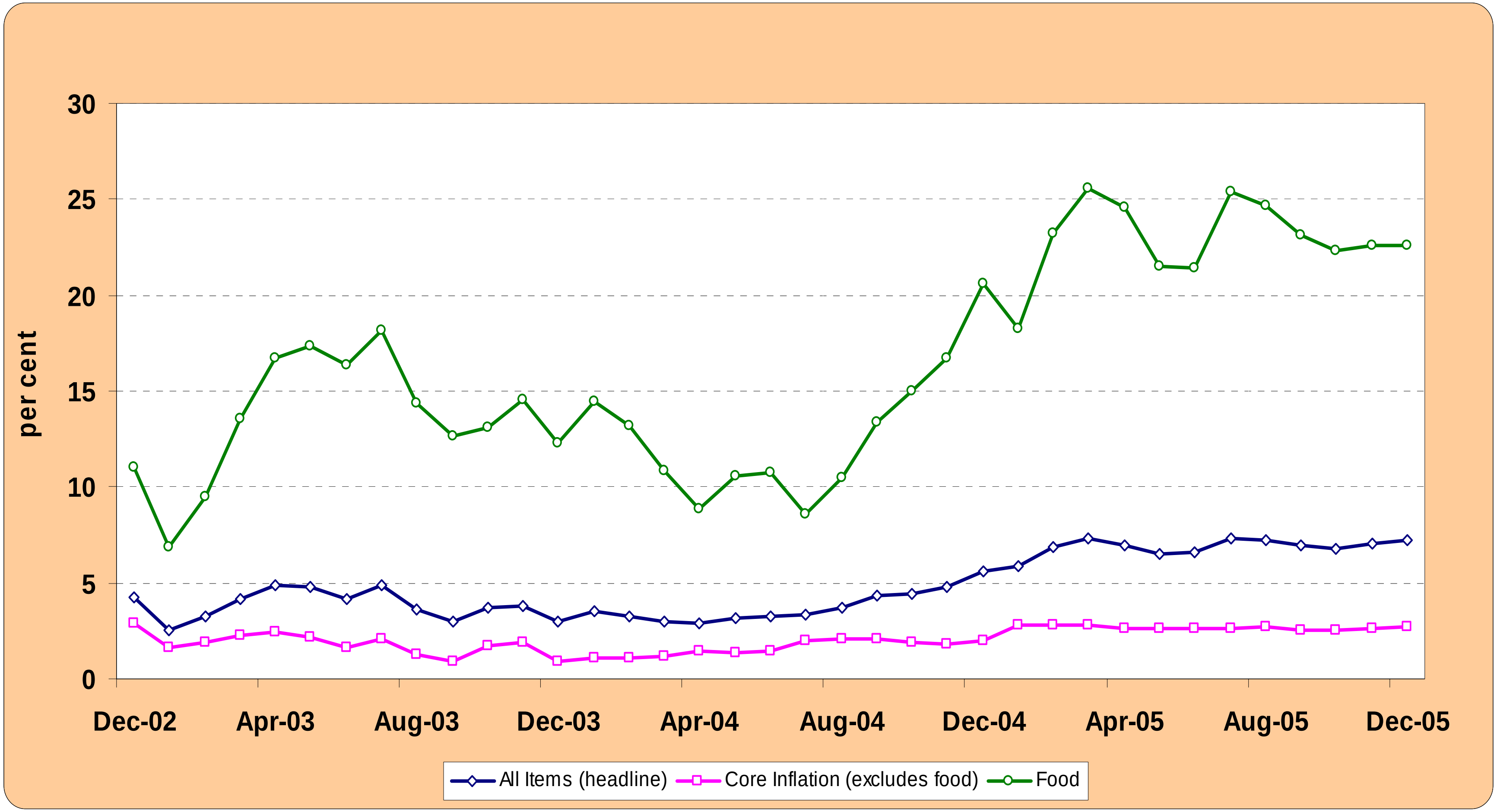
# Chart 5
# Average Yearly Wage Increases




*Data for 2005 are from January to August

Source: Employers Consultative Association; Industrial Court

# Chart 6
# Year on Year Inflation Rates



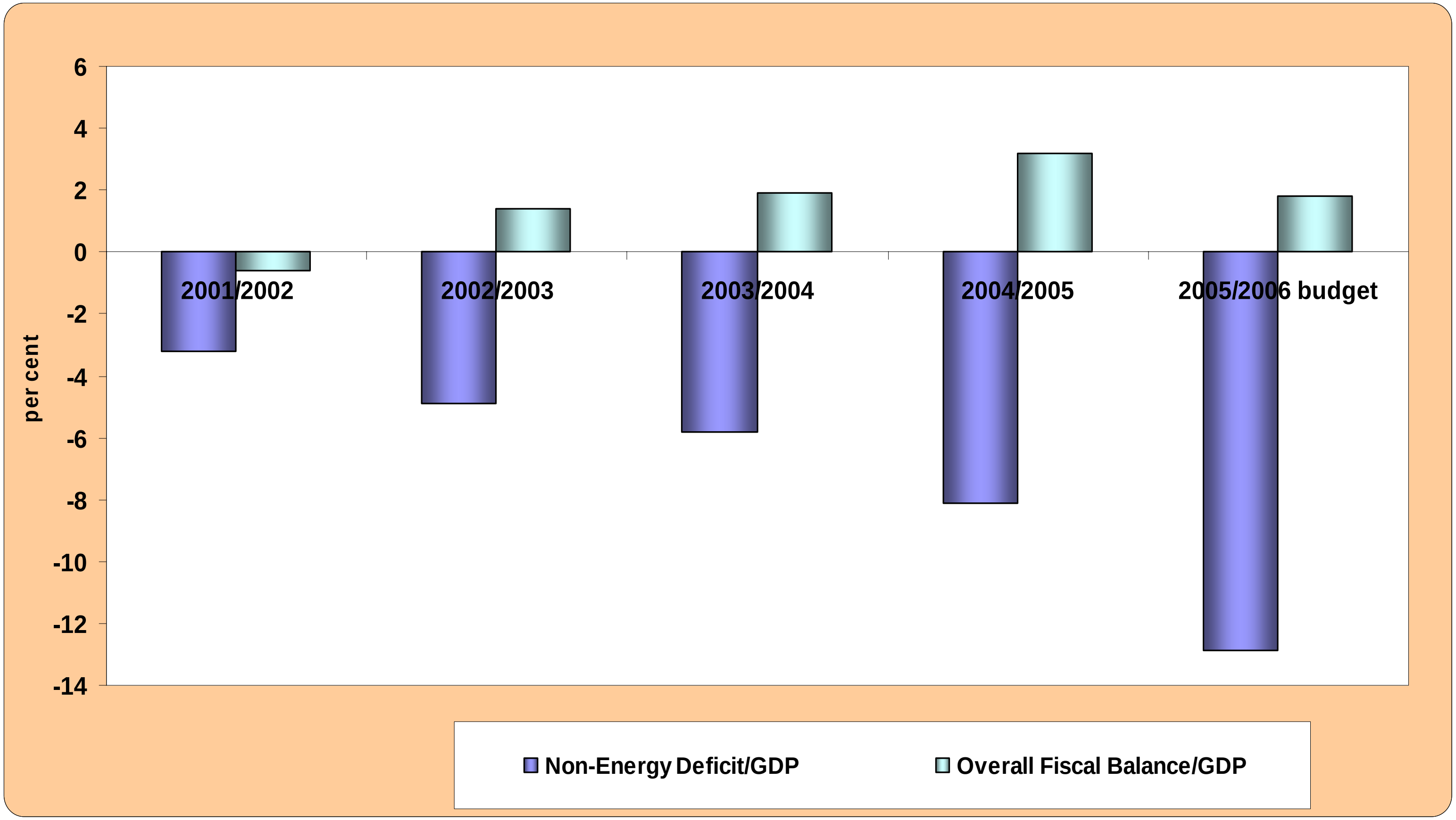

Source: Central Statistical Office

# Chart 7
# Central Government Fiscal Operations in percent of GDP

| | Fiscal Years | | | | |
|---|---|---|---|---|---|
| | **2002** | **2003** | **2004** | **2005** | **2006 (Budgeted)** |
| Total Revenue | 24.6 | 24.9 | 27.3 | 30.9 | 32.0 |
| *Energy* | 5.8 | 9.2 | *10.1* | *14.2* | *18.6* |
| *Non-energy* | 18.8 | 15.7 | *17.2* | *16.7* | *13.4* |
| Total Expenditure | 25.3 | 23.5 | 25.4 | 27.7 | 30.2 |
| Overall Balance | -0.7 | 1.4 | 1.9 | 3.2 | 1.8 |
| Non Oil Deficit | -3.2 | -4.9 | -5.8 | -8.1 | -12.9 |

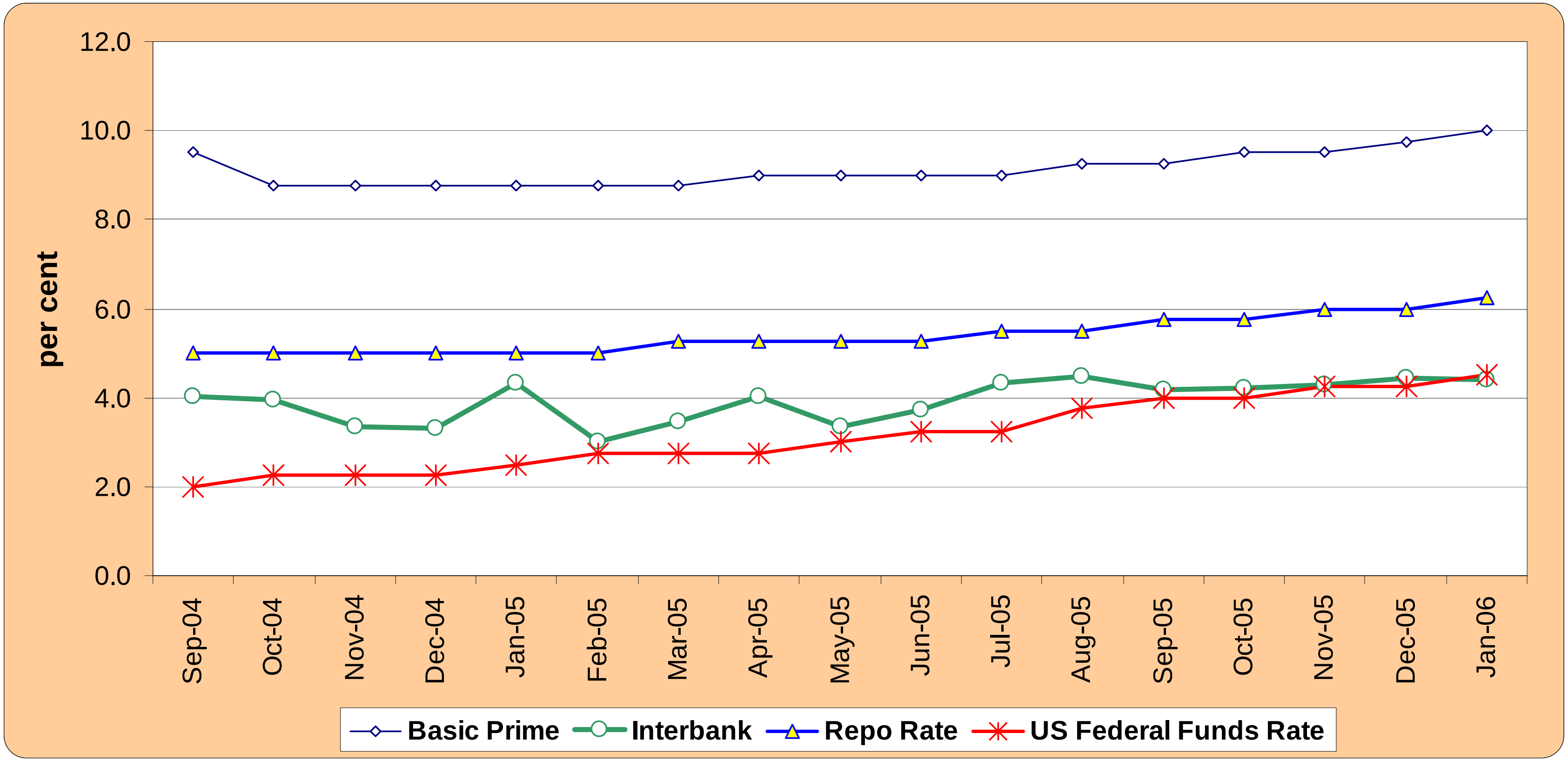
Source: Ministry of Finance

# Chart 8
# Non-Energy and Overall Fiscal Deficit




Source: Ministry of Finance

# Chart 9
# Selected Interest Rates




Source: Central Bank of Trinidad and Tobago

# Chart 10
# Macro-prudential Indicators

| | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|
| | (per cent) | | | |
| Capital to Risk Weighted Assets | 20.6 | 20.3 | 22.7 | 21.4 |
| Non Performing Loans/Gross Loans | 3.6 | 2.0 | 4.0 | 2.3 |
| Provisions/Impaired Loans | 2.6 | 2.3 | 40.3 | 61.6 |
| Return on Assets | 2.4 | 2.1 | 3.7 | 3.7 |
| Return on Equity | 20.0 | 16.9 | 27.5 | 27.5 |

**Source: FSAP Report**

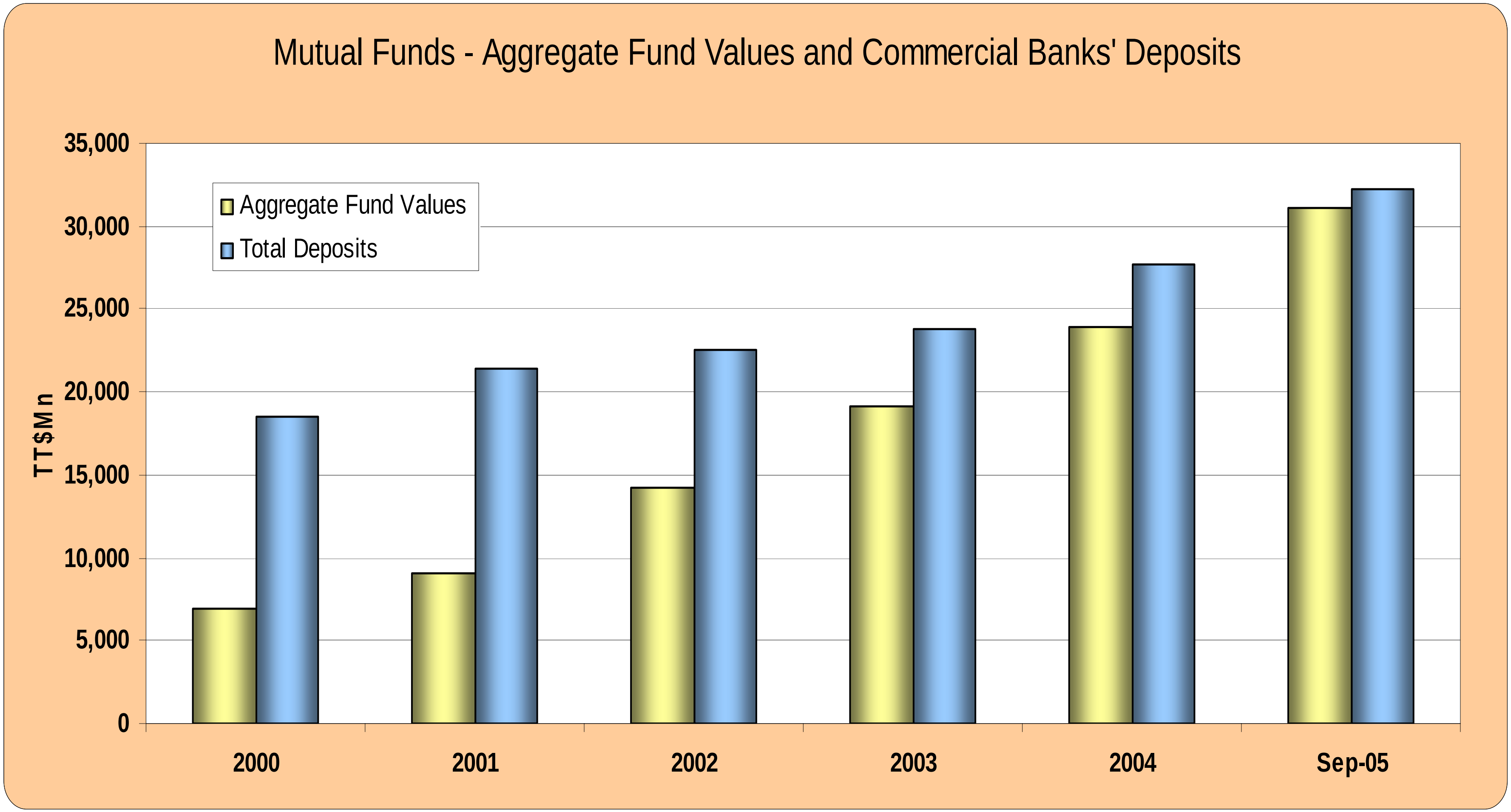
# Chart 11
# Selected Capital Outflows
US$ Millions

| | Foreign Acquisitions | Bond Placements | | | Total |
|---|---|---|---|---|---|
| | | Sovereign | Other | Total | |
| **2001** | 58.1 | 39.6 | 166.7 | 206.3 | 264.4 |
| **2002** | 105.9 | 70.1 | - | 70.1 | 176.0 |
| **2003** | 200.0 | 177.8 | 368.2 | 546.0 | 746.0 |
| **2004** | 25.4 | 230.4 | 196.9 | 427.3 | 452.7 |
| **2005** | 341.0 | 147.0 | 135.0 | 282.0 | 623.0 |

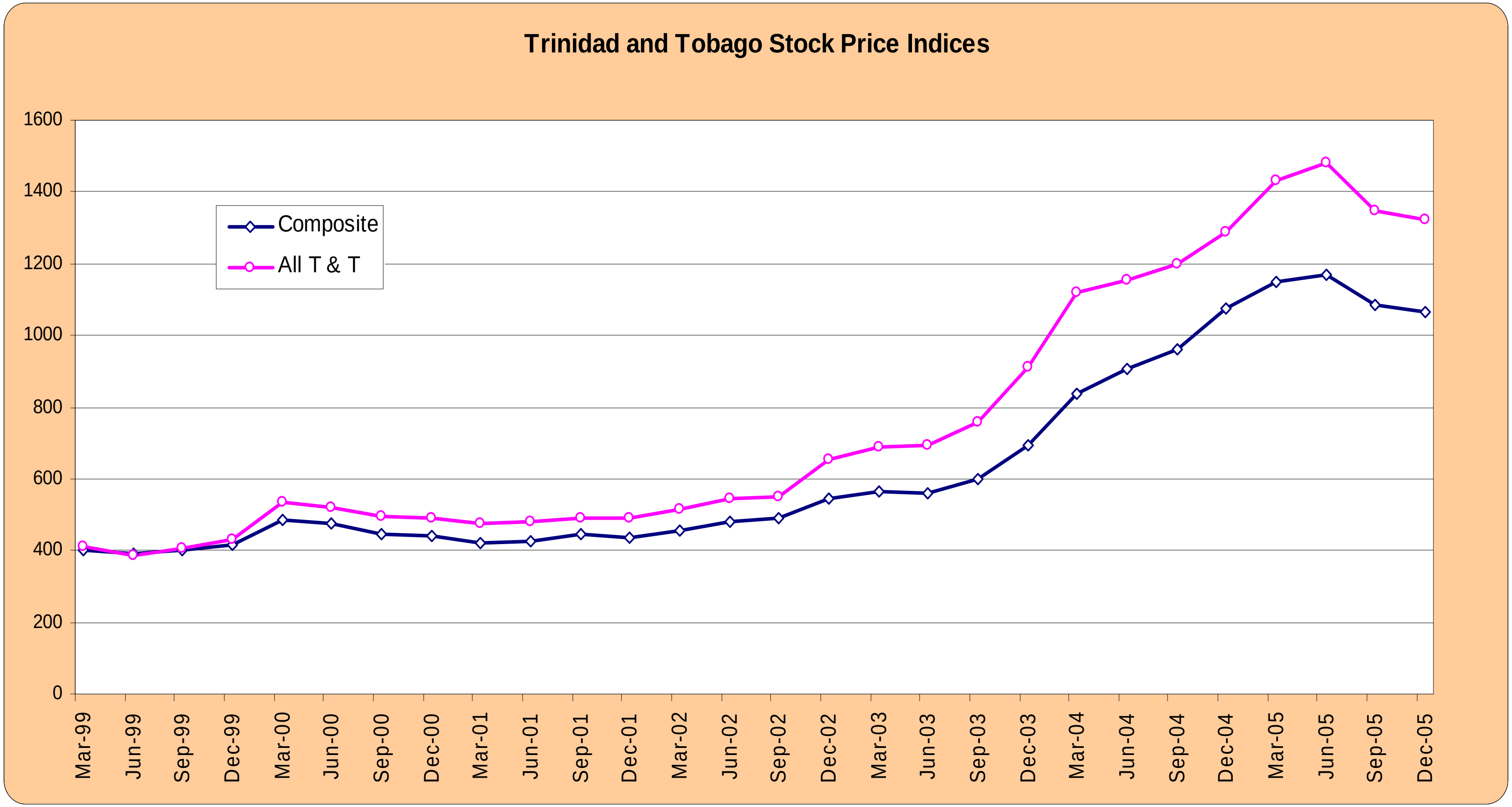
# Chart 12
# Summary Balance of Payments

| US Dollars Millions | 2001 | 2002 | 2003 | 2004 | Estimate 2005 |
|---|---|---|---|---|---|
| **Current Account Balance** | **444** | **76** | **962** | **1,788** | **2,620** |
| Exports | 4,304 | 3,920 | 5,206 | 6,403 | 8,834 |
| of which: Petroleum crude and refined | 1,735 | 1,768 | 2,386 | 1,643 | 3,038 |
| Imports | 3,587 | 3,683 | 3,912 | 4,894 | 6,186 |
| of which: Consumer Goods | 1,320 | 2,407 | 2,655 | 3,098 | 4,186 |
| **Services and transfers (net)** | **-273** | **-161** | **-332** | **279** | **-28** |
| **Capital and Financial Account (net)** | **25** | **-27** | **-627** | **-1,054** | **-818** |
| **Overall balance** | **469** | **49** | **335** | **734** | **1,802** |
| **Current Account Balance/GDP(%)** | 5.0 | 0.8 | 8.9 | 14.5 | 17.7 |
| Memoranda: | | | | | |
| Total Official Reserves (US$Mn) | 1,876 | 1,924 | 2,258 | 2,993 | 4,765 |
| *Central Bank* | *1,712* | *1,760* | *2,008* | *2,540* | *3,889* |
| *Revenue Stabilization Fund* | *164* | *164* | *250* | *453* | *876* |

# Chart 13
# Financial Savings



# Chart 14
# Stock Market Activity



# Chart 15
# Standard and Poor's
# Credit Rating for Selected Countries

| | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|
| **Jamaica** | B+ | B+ | B | B | B |
| **Barbados** | A- | A- | A- | BBB+ | BBB+ |
| **Trinidad and Tobago** | BBB- | BBB- | BBB | BBB+ | A- |

# Chart 16
# Selected Economic Indicators

| | 2004 | 2005 | 2006 |
|---|---|---|---|
| Real GDP Growth (%) | 6.5 | 7.0 | 10.0 |
| Inflation (Year on Year %) | 5.6 | 7.2 | 4.0 – 5.0* |
| Unemployment (%) | 10.5 | 8.4 | 7.0 |
| Public Sector Debt/GDP (%) | 49.1 | 41.3 | 31.8 |
| External Current A/C Balance/GDP(%) | 14.5 | 17.7 | 19.0 |
| Oil Prices (WTI) - US$ | 41.5 | 54.4 | 55.0 |

* Target

Last year was another year of strong energy-based economic growth; once again surging commodity prices and increasing exports led directly to booming activity in the energy sector and indirectly through the impact of government expenditure, on construction and services.

In 2005, real GDP grew by 6 1/2 percent with the **energy sector** growing by 11 percent and the **non-energy sector** by 4 percent [CHART 2].

Growth in the non-energy sector was led by construction (8 percent), distribution (4 percent) and manufacturing (5.1 per cent) [CHART 3].

With the strong increase in aggregate demand, over the last couple years, the labour market has tightened. Unemployment has fallen to an all-time low (to around 7-8 percent) and labour participation rates are at all time highs [CHART 4].

The demand pressures and the tightening of the labour market are now beginning to be reflected in an increase in the supply price of labour.

Negotiated wage increases for unionised labour have also taken an upward drift [CHART 5].

Wages in specific sectors like construction have gone up and this has exerted upward pressure on wages in the services sector. Wages for skilled labour and salaries of professional and managerial grades have shown the largest increases.
Rising domestic demand and supply problems in the agricultural sector have contributed to an upturn in **headline inflation** which reached 7.2 percent year-on-year in December 2005.

The uptick in inflation was led by the surge in food prices which rose by a sizable 23 percent, year-on-year. [CHART 6].

However, core inflation, (a measure that excludes food prices) which is a better measure of underlying demand conditions, has also risen from 2 percent at the end of 2004 to 2.7 percent as at December 2005.

Given the structure of our economy, our rising oil fortunes are reflected most noticeably in the significant increase in central government revenues.

Specifically, total tax revenue has increased from about one-quarter to about one-third of GDP from fiscal year 2002 to the current fiscal year. This is entirely as a result of the near-trebling of revenue connections from the energy sector, from 6 percent to 18 percent of GDP. Tax collections from the non-energy sector have declined in terms of GDP from 19 percent to a projected 13 percent of GDP in 2006.

Like the other oil exporters in the Western Hemisphere (Ecuador, Mexico and Venezuela) Government expenditure has increased sharply in response to the oil windfall.

The Government has followed the international best practice of basing expenditure levels in the annual budget, on the long-run notional oil price, while saving any excess in the interim Oil Stabilisation Fund.

Even employing this formula, Central Government expenditures have increased from 25 percent of GDP in **2002** to 28 percent of GDP in 2005 and to a projected 30 percent of GDP in 2006 [CHART 7]. Much of the increase in Central Government expenditures is directed to the education and health sectors, and to national security.

In addition, however, several quasi-governmental agencies are expending sizable sums on infrastructural projects financed by market borrowings.

I should note that outstanding public debt is still at a relatively comfortable level of 40 per cent of GDP, while government external debt is at a very low 9 per cent of GDP.

The sudden sizable increase in government expenditure has raised questions about capacity constraints and long-term sustainability.

Because of the inherent volatility of oil prices, the fact that oil and gas resources are exhaustible assets and the difficulty of reducing government expenditures in the short run, the **non-energy fiscal balance** has become an important analytical tool for oil-exporting economies. The non-energy balance is used as an indicator of the underlying strength of your fiscal regime (devoid of the "temporary" wealth derived from oil and gas).

[Chart 8] shows the evolution of the overall fiscal balance and the non-energy fiscal deficit from fiscal year 2002 to the current fiscal year.

Following upon an increase of about one and a half percentage points to 7.7 percent of GDP in fiscal 04, the non-energy deficit is projected to virtually double to about 13 percent of GDP in 2005/2006.

A little less than one-half the increase in the non-energy deficit is due to lower revenues (following the reduction in personal and corporate income taxes) and the remainder is due to an increase in capital expenditures under the Infrastructural Development Fund.

The widening of the non-energy deficit exposes the Government accounts to the risks of sudden declines in energy prices.

The sizable non-energy deficit has also contributed to high levels of **liquidity in the financial system** reducing the efficiency of monetary policy. Since the end of 2004, the Central Bank has sought to tighten monetary policy by raising domestic interest rates. However, the liquidity overhang has tended to blunt the transmission of the interest rate signals. The Bank has recently adopted a more aggressive liquidity absorption policy to address this problem.

In the context of our restrictive monetary stance, there has been a sharp increase in interest rates during 2005 [Chart 9] (the prime rate which had fallen to 8.5% in 2004 now stands at about 10%).

The financial sector has been a main strength in our economy – and this is an important safeguard against exogenous shocks to which Trinidad and Tobago as an oil-based economy is subject.

This strength is clearly illustrated by the evolution of the main macro-prudential indicators [Chart 10].

- Capital adequacy is at 21 percent, much higher than the 8 percent minimum;
- Non-performing loans have declined; and
- Banks are showing very healthy rates of return.

The strength of the financial sector, combined with our ample foreign exchange reserve situation, has made Trinidad and Tobago the financial centre of the region.

Over the past five years outward direct investment has been estimated at close to US$750 million, while foreign bond placements in the Trinidad and Tobago markets, by regional sovereigns and private corporations have been estimated at US$2.3 billion. [Chart 11]

With the oil and gas sector accounting for 80 percent of exports, surging oil prices have boosted the **external current account** surplus to 18 percent of GDP in 2005 [Chart 12]. This has facilitated a growth of official external reserves.

But there are areas of concern even in the balance of payments. Among these are:

(i) growth in non-energy exports remains sluggish (if this has to do with the constraints of the CARICOM market, the question is why we are not exploiting extra regional markets more aggressively);

(ii) consumer imports continue to increase at a very rapid clip; and

(iii) there is a disturbing level of unidentified capital outflows.

Financial markets have generally been buoyant in reflection of the ample liquidity. Most financial institutions have experienced rapid asset accumulation with mutual fund investments in the lead [CHART 13].

After a prolonged bullish run, the stock market index leveled off in 2005. Analysts see this as a kind of self-correction and a reaction to the recent rise in interest rates [CHART 14].

In August 2005, Standards and Poors raised Trinidad and Tobago's foreign currency debt rating to "A-", providing a boost also to the credit-worthiness of local companies [CHART 15].

**Short Term Prospects**

In the short run, Trinidad and Tobago's outlook remains favourable owing to expanding oil and gas production. The full year's production of Atlantic LNG combined with the high and increasing level of public sector construction activity should help boost GDP growth to 10 percent in 2006.

Expected high oil prices and continued expansion in the volume of energy sector exports will continue to strengthen the balance of payments and increase net international reserves.

Our main short-term challenges will be to maintain financial stability in the face of buoyant domestic demand, capacity constraints and (expanding) liquidity related to the large non-energy fiscal deficit.

The Central Bank will need to maintain a tight monetary stance to address inflation and moderate pressures in the foreign exchange market. Incomes policy could also pose a challenge.

**Longer Run Considerations/Sustainability**
Our national resource endowments put Trinidad and Tobago in an enviable position, in many respects, **but one that comes with several challenges**.

It is widely acknowledged that our long-term pre-occupation should be to use the energy sector windfall to develop a strong viable and sustainable on-shore economy that guarantees sustainable increases in living standards for all.

The question is, are we on the road to doing this? No doubt, we have taken several positive steps to this end, some of which are:

- the Government's intensified focus on education and training reflected, in part, in the establishment of the University of Trinidad and Tobago;

- the planned broadening of the industrial sector through new clusters of industrial estates, at least one of which is earmarked for high value technology industries;

- initial steps to put in place a more efficient tax regime to provide greater incentives for savings and investment;

- the establishment of the Revenue Stabilisation Fund (one objective of which is to save some of the revenue wealth for future generations).

But there are some aspects that still need to be addressed comprehensively and these include:

- a more concerted focus on the **development of agriculture**;

- upgrading of the country's infrastructure (the road network, drainage, the public utilities; and

- putting our public finances on a sustainable long-term footing.

**A Word About the Latter**
Even the normally conservative projections of the multilateral agencies expect that oil prices will remain high for the rest of the decade. They advise, however, that oil exporters take a cautious approach to increasing government spending.

Given some of the social and infrastructural deficiencies that we face in Trinidad and Tobago, some increase in Government expenditures to correct for income inequalities and to facilitate rapid diversification is clearly justified.

The challenge is arriving at the **correct balance between spending and saving of the energy windfall**. And this also implies establishing expenditure priorities (both as regards current expenditures such as energy subsidies and capital projects).

As a general rule both short-run and long-term sustainability considerations argue for some **re-phasing of expenditures and an increase in savings through the Revenue Stabilisation Fund**. A non-energy fiscal deficit at present level (13 percent of GDP) is clearly unsustainable and the issue is the pace at which this should be reduced.

A front-loaded fiscal tightening – through, for instance, the re-phasing of expenditures would help address current excess demand pressures, ease the burden on monetary policy, perhaps further boost the country's sovereign credit rating and would reduce the economy's vulnerability to a negative oil price shock.

An increase in savings in the Stabilisation and Heritage Fund would allow a larger build-up in financial assets which would provide a steady stream of income to maintain budget expenditures even when our energy resources are depleted. (That is what Norway has done very successfully).

With our other endowments and our oil and gas resources, Trinidad and Tobago is clearly blessed.

With good planning and economic management **we could almost have our cake and eat it too**.

The End