Winston Dookeran: The state of the economy in Trinidad and Tobago and the outlook for 2001

Address by Mr Winston Dookeran, Governor of the Central Bank of Trinidad and Tobago, to the Trinidad and Tobago Chamber of Industry and Commerce, 16 May 2001.

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Good morning ladies and gentlemen once again it is a pleasure to be here to address you today. In keeping with past discussions I want to share with you my thoughts on the state of the economy today. Some analysts in the media have commented on a number of current economic issues e.g. the possibility of a slowdown, interest rates, private sector credit, consumer confidence. Today, however, I want to focus on five main themes and perhaps I may be able to clarify some of these topical issues. My themes are as follows: -

1. What are the major characteristics of our current economic expansion and how does this expansion differ from previous ones?
2. What is the nature of private sector credit in the economy at this time?
3. What is the current monetary policy framework?
4. What impact if any will the current slowdown in the US have on the local economy?
5. What are the major downside risks and challenges as we continue into 2001?

Introduction

Trinidad and Tobago is entering the eighth year of a long period of economic expansion, the second time in the post independence period that we have had such an experience. This expansion is significantly different from that of the mid and late seventies although there are several similarities. In particular this current phase of continuous growth has not been directly driven by an improvement in the country's terms of trade as occurred in the 1970's with the first oil shock. Indeed in the present period higher commodity prices have supported the buoyancy in the economy while the sustained level of growth we are now experiencing is a direct consequence of the policies introduced during the adjustment phase of the 1980's.

You may recall that Trinidad & Tobago introduced a number of structural reforms in the aftermath of adjustment – trade, tax, privatization, tariff and financial reforms – that provided a platform for the current investment upswing in the oil and gas sector in particular. Many analysts have suggested that the market – friendly reform policies which were undertaken and the investments made thereafter contributed significantly to the current economic performance. Today the economy is reaping the rewards of these first generation reforms and as the economic conditions continue to improve, the time will be appropriate to introduce second-generation reforms such as labour market reforms, pension reform and institutional changes in the educational, health and social security systems.

The long expansion has been characterized by moderate inflation rates and consistently lower levels of unemployment. This is in sharp contrast to two decades ago when the growth in the economy was accompanied by double digit inflation. We have been able to manage our affairs to keep in check those domestic sources of inflation. As we go forward we need to ensure that wage settlements remain in line with productivity. One measure of productivity in the manufacturing sector for Trinidad and Tobago suggests that output per man hour worked grew by 3.3 per cent for the first nine months of 2000 compared with 7.1 per cent for the corresponding period of 1999.

The strength of the country's performance is also evident in the healthy state of the external accounts where the country recorded an overall balance of payments surplus in 2000 – the eighth such consecutive surplus. This has also led to a build up in the country's gross foreign reserves which amounted to US$1,890 million or around 5.2 months of prospective imports.

The state of play

Over the past seven years real GDP has grown on average at just under 4 per cent per annum and preliminary indications are that growth will continue apace during 2001. Despite the slowdown in the fourth quarter of 2000, when real GDP rose marginally (0.4 per cent) the economy has rebounded in the first quarter of 2001 growing by around 1 per cent, considerably higher than the 0.2 per cent recorded one year earlier. At that time the delay in settling the natural gas contract impacted negatively on economic activity in the energy based industries and these adverse developments continued well into the second quarter of 2000, when the natural gas contract was eventually signed. For example, the protracted negotiations led to a reduction in the volume of fertilisers exported to international customers, and also affected other sub-groups in the energy sector. For 2001 however the sector is expected to operate at or near capacity with minor stoppages.

In the non energy based sectors of the economy, the 2000 performance is noteworthy in that for the first time in more than four years, every sector experienced positive growth: – Agriculture rebounded from two difficult years as the output of raw sugar totalled 107 thousand tonnes. Construction activity has slowed after spikes in 1997 and 1998 consequent on the installation of additional capacity in the energy based sectors, but some slowdown was expected as the major investments and public sector capital spending on infrastructure began to taper off. This tapering off will help to keep in check any overheating in these sectors of the economy.

While the longer-run inflationary trend (or core inflation) remained subdued with the inflation rate for 2000 registering 3.6 per cent compared with 3.4 per cent in 1999, short run supply shocks continue to impact the level of retail prices. In 1998 floods and drought contributed to a spike in the annual inflation rate. A similar situation occurred in 2000 as flood damage adversely affected the supply of fruits and vegetables in November and as a consequence prices rose sharply towards the end of the year. Since then average consumer prices have fallen in January and March with the inflation rate for the first quarter set at 1.5 per cent compared with 2.7 per cent in the fourth quarter of 2000.

The improvement in the country’s terms of trade in 2000 was reflected in the fiscal accounts as buoyant oil prices contributed to an almost balanced budget for the fiscal year 1999/2000. The trend of higher than budgeted oil prices continued into 2001 and into the new fiscal year. Preliminary evidence suggests that for fiscal 2000/2001 the central government will achieve an overall surplus of just under 0.5 per cent of GDP.

Indeed for the first six months of the fiscal year, the government recorded an overall surplus of $473 million as actual oil prices averaged around US$30 well above the budget estimates. Despite this performance there are some downside risks to the fiscal position. The downside risks arise from the possibility of a sharp reversal in the terms of trade with oil prices falling well below US$20 as well as the inability of the central government to keep the reins on the transfers and subsidies element of the budget – especially transfers to public enterprises and utilities. Preliminary estimates show that transfers are projected to rise from 7.8 per cent of GDP in fiscal 1998/1999 to 9.2 per cent in the current fiscal year. While the central government may achieve an overall budget balance in the current fiscal year we at the Central Bank continue to focus on the high level of fiscal injections associated with these activities as there are implications for liquidity management.

During fiscal 1999/2000 the central government established a Revenue Stabilisation Fund in which it is estimated that two thirds of the excess of actual oil revenues over budgeted revenues will be placed. At the end of the fiscal year just over TT$400 million was placed into this Fund and given the general trend in oil prices for the current fiscal year a similar amount may accrue to the Fund. For those economies which are dependent on non-renewable resources such as oil and gas, the depletion of the countries wealth over time raises issues of inter-generational equity and fiscal sustainability. The establishment of a revenue stabilisation fund goes some way towards addressing these issues.

Money, credit and interest rates

As you are aware our current monetary policy framework is focussed on liquidity management and exchange rate stability which is directed towards ensuring internal and external price stability – the internal and external value of the currency. Liquidity conditions must be managed to ensure that business credit is not retarded especially during periods in which the public sector is a major player in the money and capital market.

During 2000 private sector credit by the commercial banks expanded by 14.5 per cent compared with a 12 per cent growth in the previous year. These developments were taking place alongside an increase of 30.5 per cent in credit by non-bank licensed financial institutions reflecting an increase in the holdings of private sector investments. It is against this background understandably that credit growth from the commercial banks has slowed in the first few months of 2001. All components of credit fell except credit to business firms which grew by 4.4 per cent in the first two months of the year. Nonetheless private sector credit as a percentage of GDP remains at around 38 per cent of GDP around the same levels as were evident in 1999 and 2000. Over the past several years many businesses relied on overdraft financing as their preferred method of business finance. The high cost of financing these operations, the imperative for many firms to be internationally competitive, the improved economic climate and the generation of internal sources of funds (retained earnings) suggests that more business firms may wish to change the nature of their business finances as they begin to generate more internal funds and begin to make more use of the domestic capital market.

Cash reserve requirements for commercial banks

The growth in credit over the past two years has taken place against the backdrop of a growing economy, large fiscal injections, a prime rate of 16.50 per cent and a cash reserve requirement for commercial banks of 21 per cent of designated liabilities – that is deposit liabilities and other fund-raising instruments. At 21 per cent the cash reserve ratio for commercial banks is relatively high and indeed represents high intermediation costs. The Central Bank is committed to lowering the cash reserve requirement over the medium term especially as the Bank moves away from a reliance on direct instruments of control to more market oriented policy tools. In respect of the latter Open Market Operations (OMO) were introduced almost five years ago and are now undertaken routinely. In respect of the direct controls the Bank has begun to rationalise reserve ratios in the commercial banking system. Changes will take place only when monetary conditions permit.

You may be aware that commercial banks earn no income on cash reserves and this represents a cost to banks and must be recovered in the spread between loan and deposit rates. A reduction in the reserve requirement will lead to either lower deposit rates or lower loan rates or some movement in both that will lead to a narrower spread. Thus the reduction in the reserve requirement from 21 per cent to 18 per cent – which is effective from the reserve week beginning today - will lead to a fall of about $376 million in the amount that commercial banks need to hold in cash at the Central Bank. To ensure that there is no impact on current liquidity conditions these funds have been re absorbed with a simultaneous issue of government securities to the commercial banks. The Central Bank expects that the reduction in the cash reserve ratio initially will impact the loan rates in the banking system so that borrowing costs will be lower.

Capital market developments

Over the long period of expansion the domestic capital market has been able to meet the needs of domestic firms as well as the public sector when the need arose. Over the last two years the domestic capital market has witnessed what some have termed the internationalization of the market as Trinidad and Tobago has emerged as a regional financial centre. Several regional governments and quasi-public sector entities have raised US dollar financing on the domestic market. Indeed between 1999 and 2000 US$195 million was raised by regional governments (Barbados, Belize, St. Lucia) on the domestic capital market while TT$6,640 million was also issued in bond financing over the same period to local companies and para statal companies; all this points to the growing ability of the domestic capital market to supply long term funding.

These developments augur well for our capital market but as the volume of transactions grow there must also be some additional institutional changes. As more governments and regional corporations enter this market, the absence of an independent benchmark measure of risk, the pricing of these securities, the absence of good credit analyses – all point the need for the establishment of a regional credit rating agency. Perhaps the time is right and it may well be a good idea for the private sector interests to explore the feasibility of the establishment of such an institution.

Implications of the slowdown in the United States

There has been a lot of discussion recently on economic conditions in the United States and its impact on the local economy. Growth in the United States slowed to 1 per cent in the final three months of 2000 prompting a number of commentators to suggest that the United States economy was heading towards a recession. However, if one were to follow the strict methodology for the dating of business cycles in the United States, the onset of a recession is marked after three consecutive quarters of negative growth. Without getting into a debate on semantics this is not the current situation in the United States.

It must be noted however that some slowdown in growth was expected given the pace of expansion witnessed in the United States over the 1990's. While the pre-emptive action taken by the United States Federal Reserve in 2000 had contributed to the slowdown, the economy has also been impacted by what some analysts have termed a series of shocks:- higher energy prices especially the spike in natural gas prices and the energy crisis in California, the tightening of credit, a fall in equity markets, a significant decline in the price and earning potential of technology stocks. Recent data show that the economy rebounded with an annual growth rate of 2 per cent in the first quarter of 2001 as aggregate demand fuelled by consumer spending contributed to this performance.

Lower commodity prices which are now emerging at the beginning of 2001 represent one channel through which the United States 'slowdown' may impact the domestic economy. For every US$1 per barrel fall in the price of oil, government's receipts from the energy sector will be lower by TT$154 million. However the budget for fiscal 2000/2001 was based on an average oil price of US$22 per barrel and prices are unlikely to fall below US$22 for the remainder of the fiscal year. In respect of export earnings these exports to the US are not expected to be adversely affected as most of these commodities are sold under long term contractual arrangements.

Outlook for 2001 and possible risks

Real GDP is expected to grow at around 4½ per cent in 2001 with inflation estimated at just below 4 per cent in the absence of any major supply shocks. As I indicated earlier the public sector should achieve an overall surplus of just under 0.5 per cent of GDP with crude oil prices holding at around current levels in the range of around US$25 a barrel. In line with the moderation in energy prices the current account surplus of the balance of payments is expected to be lower in 2001, but nevertheless an overall surplus of about US$400 million – around the level achieved in 2000 – is expected and should contributed to a build up of net official reserves in 2001 to around US$1,845 million (5 months cover).

You may well ask what are the downside risks to such a positive scenario and I can think of two critical ones. The first of these has been mentioned already i.e. the possibility of a sharp reversal in the commodity terms of trade. As a primary producer and exporter, Trinidad and Tobago is dependent on our oil and gas exports. Over the years the economy has become more resilient to these price changes but we still guard against their sudden reversals.

While the current slowdown in the US does not pose a major threat to our exporters, we need to be on our guard against US steel interests seeking to introduce further curbs against steel imports as occurred a couple of years earlier.

A second downside risk falls within the area of fiscal management. Buoyant oil prices have allowed the fiscal authorities to balance their accounts but we need to continue to work towards ensuring buoyancy in non-energy taxes, overall public sector surpluses and a reduction in the transfer and subsidy budget. Failure to do so may lead to erosion of the gains made in the aftermath of the adjustment period.

Future challenges in public policy

On the basis of the current macroeconomic performance the medium term outlook appears to be relatively favourable for Trinidad and Tobago. Nevertheless there are still a number of public policy challenges to be faced over the next few years. The first challenge relates to the diversification of the Trinidad and Tobago economy. Away from an over dependence on crude oil, Trinidad and Tobago has been transformed into an oil and gas economy, more significantly since the establishment of Atlantic LNG. The planned expansion of Atlantic LNG with Trains II and III together with the most recent natural gas finds suggest that the country may be well on its way to becoming a major supplier of gas based products, which also opens the possibility of expanding our production frontiers with new value added industries in this sector.

A second challenge which remains is the improvement of the physical infrastructure – electricity, water and communications. The abundance of natural gas should ensure that the country's electricity needs are satisfied at relatively low costs. However much more needs to be done in the area of improvement of water supplies not only for commercial customers but for domestic purposes as well. The desalination plant slated to be open at year's end should relieve WASA of most of its commitments to the Point Lisas Estate. The communication sector must meet the challenge of modernisation with state of the arts communication network infrastructure.

In my concluding remarks, I want to stimulate some discussion on the notion that a major challenge facing small Caribbean states such as Trinidad and Tobago is that of industrial competitiveness. When I speak of industrial competitiveness, I am referring to the ability of a country's industries to withstand competition by rapid export expansion and technological upgrading of its industries. We are all certainly aware that with the pace of globalization and phasing out of special preferences enjoyed by small states, the need for a coherent competitiveness strategy model becomes of critical importance.

The attainment of industrial competitiveness is also the key to the achievement of overall national competitiveness where a nation is able to sustain high rates of economic growth while at the same time maintaining and expanding the real incomes of its people over the long term. I must stress that strong industrial competitiveness depends in large measure on:

i. trade, foreign investment and macro policies;

ii. skills, technology institutions and finance and last but not least;

iii. infrastructure.

It is clear that for Trinidad and Tobago to take a prominent role in the new global framework, policy makers must embark on goals to hasten industrial competitiveness.