

Jwala Rambarran: Monetary policy presentation for November 2014

Speech by Mr Jwala Rambarran, Governor of the Central Bank of Trinidad and Tobago, at the Chaguanas Chamber of Industry and Commerce, Port-of-Spain, 1 December 2014.

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Ladies and Gentlemen,

I thank the Chaguanas Chamber of Industry and Commerce for graciously agreeing to host our third Monetary Policy Forum. Events such as this Monetary Policy Forum are important to Central Bank's communication strategies, as communication is now the new monetary policy tool for central banks around the world. From Debe to Tobago and now Chaguanas, this Forum provides a platform to explain the thinking behind our monetary policy actions, interact with stakeholders and account to the national community, who we are here to serve.

As we enter the final month of 2014, global economic prospects are muted compared to the more optimistic sentiments which prevailed at the start of the year. Recovery from the global crisis is taking longer than anyone expected. More than a half decade onwards and many countries are still struggling with painful legacies of the crisis, including extraordinarily high debt and soaring unemployment and it's not yet over.

The Managing Director of the International Monetary Fund, Christine Lagarde, at the recent Annual Meetings of the IMF and World Bank, talked about the "new mediocre" as the descriptor for low economic growth which is now the new reality. In the advanced economies, the United States grew at its fastest pace in over decade and the United Kingdom is showing encouraging signs of steady growth. Recovery in the Eurozone remains fragile. Japan's economy has slipped back into its fourth recession since 2008.

Emerging markets, which fuelled a great deal of global activity in the recent past, are likely to do their heavy lifting at a slower pace than before. Output growth in China, the world's second-largest economy, has slowed to a five- year low. The Indian economy is rallying, while the other two members of the BRIC bloc, Russia and Brazil, are facing significant headwinds to growth.

Still on the international front, there are dark clouds gathering. These clouds coming from the United States are bringing murky conditions associated with normalization of US monetary policy. These conditions have the potential to have a powerful impact on emerging market economies such as Trinidad and Tobago, when they reach us.

As expected, the US Federal Reserve ended its era of quantitative easing at its October 2014 meeting. Next year, for the first time in eight years, we are likely to see a hike in the Fed funds rate, probably in summer of 2015. There is considerable uncertainty in global financial markets about the pace and magnitude of these expected increases in US interest rates.

For Trinidad and Tobago, this uncertainty could result in a weakening of capital inflows or acceleration of capital outflows. Central Bank of Trinidad and Tobago is already putting measures in place, through available monetary policy tools, such as increasing its policy interest rate, to insulate our economy, as much as possible, from the shocks we are expected to feel by rising US interest rates.

Apart from the dark clouds hovering in the United States, geopolitical risks are mounting in various parts of the world. We started 2014 with a possible escalation of conflict between Russia and Ukraine. We are ending the year with an Ebola outbreak in Africa and an upsurge of ISIS in the Middle East.

So, you will realize I have gone through the trouble of first raising these murky international matters as they are early warning signs for global financial markets. Developments on

battlefields across the world can have an impact on our small island state. This is why I have raised them as they set the tone of how things are likely to unfold.

Recent economic developments

I'll begin with a brief overview of domestic economic conditions. Following no growth in 2010 and in 2011, our economy recovered by approximately 1 ½ percent in 2012 and grew by 1.7 percent in 2013. In early 2014, Central Bank expected the Trinidad and Tobago economy to have continued its recovery, with growth projected at 2½ percent. For a number of reasons, this did not materialize.

Central Bank's latest economic review of the year now indicates economic growth is likely to be a modest ½ percent for 2014. This, of course, is well below our forecast for economic growth, made at the beginning of the year, of 2 ½ percent. So what accounts for this deviation? How could we the experts, as well as other agencies such as the IMF, S&P and our own CSO, get it so wrong?

The unexpected slowdown in the economy was caused by a dismal performance in the energy sector, with declines most pronounced in natural gas and LNG production. Energy companies had indicated, in October 2013, the planned supply shutdowns and stoppages that had been taking place for the past two years would be no more and energy production would have normalized in 2014. However, supply disruptions mainly from the two largest energy companies continued throughout 2014 and stifled the recovery process.

In January and May 2014, bpTT took down the company's largest production platform, Savonette, to facilitate drilling activities. BGTT had a planned shutdown of its Dolphin platform for five days in June 2014 to facilitate the installation of equipment required for the Starfish development programme. BG also took the opportunity to undertake a parallel maintenance exercise. These are just a few instances of shutdowns by the country's two largest natural gas producers. Routine maintenance by Atlantic LNG Train 2 facility and Petrotrin's oil refinery worsened the situation in our energy sector.

Energy output, therefore, contracted by an estimated 1 ½ percent in the first nine months of 2014. Energy production rebounded to an extent – within the last two months but not strong enough to compensate for the prolonged sharp drop in output. NGC's gas pipeline leak over the last few days, which led to the shutdown of the country's main power provider, is expected to be resolved soon and should not have a significant impact on production. Central Bank expects growth in the energy sector to decline by a little over 2 percent in 2014.

This is the harsh reality to which we are tied in an energy- based economy. The bright spot of news in the midst of all these dreary developments came from the non-energy sector, as its steady performance prevented the economy from veering completely off its growth trajectory. Output in the non-energy sector increased by just over 2 percent in the first nine months of 2014 and indications of non-energy performance remain encouraging in the final quarter of 2014. Overall growth in the non-energy sector is expected to be around 3 percent in 2014, which surpasses Central Bank's projected growth rate of 2 percent. Much of the growth in the non-energy sector has been concentrated in three areas – construction, distribution and finance.

In the construction sector, local sales of cement have been expanding strongly, reaching almost 8 ½ percent in the first nine months of 2014. Higher construction activity reflects several on-going, large public sector projects such as the Point Fortin Highway, the Children's Hospital, the National Aquatic Centre and the Port at Galeota. Further impetus is coming from private sector projects breaking ground, such as the "C3" movie and shopping complex in Corinth, South Trinidad.

New car sales – a main indicator of distribution activity – are still hitting double-digit rates. Dealers sold just under 14,000 new cars in the first nine months of 2014. At the end of

November, we had already reached near the 4,500 marker on the PDE series. For the first time in five years, new car sales have surpassed 18,000 units on an annual basis.

Low interest rates, high liquidity and the cautiously optimistic sentiment of the business community have supported the expansion in private sector lending. The recovery in business lending which emerged in the first quarter of 2014 strengthened as the year progressed. Over the nine months leading up to September 2014, business lending increased by an average of 4 ½ percent compared to an average decline of nearly 4 percent over the same period in 2013.

Consumer loans continued to accelerate into 2014. The expansion in consumer loans averaged 7 ½ percent over the period January to September 2014, up from an average increase of 5.0 percent over the first nine months of 2013. A disaggregation of consumer credit showed strong growth of loans for the purchase of vehicles, home renovation and debt consolidation. Record low mortgage rates continue to spur demand for real estate mortgage financing.

I now turn to a matter grabbing headlines and generating intense interest in the country over the past month – falling international crude oil prices and the impact on the budget.

Prices for West Texas Intermediate (WTI) fell by 30 percent since the start of the fiscal year on October 1st to a four-year low of US\$66 per barrel, last Friday, following OPEC's decision not to cut output. This is lower than the 2014/2015 Budget estimate of US\$80 per barrel. The weakness in oil prices is due to abundant global supply from OPEC and the United States combined with slower growth in world demand especially from Europe and China. The general expectation is lower crude oil prices could persist for some time.

There are several reasons why we should be concerned about falling oil prices but I hasten to add, we should not suffer a panic attack or hyperventilate yet. First, we have become accustomed to using the oil price as a psychological barometer of our economic forecast of sunny skies or murky weather. Oil prices rise...we feel euphoric; oil prices fall...we feel "doom and gloom" and reach for a paper bag to breathe into. This see-saw sentiment neglects the fact there is another even more important, but apparently not as well known, barometer of our economic outlook. I refer to the natural gas price. This is not breaking news, ladies and gentlemen, and members of the media. Trinidad and Tobago became a gas-based economy 18 years ago in 1996.

Last year, we produced about nine times more natural gas than crude oil on an energy equivalent basis. A large portion of our energy production and exports are natural gas-based. At Central Bank, we estimate natural gas now contributes roughly 70 percent to Government revenue and oil the remaining 30 percent.

The second reason we should not panic over plummeting oil prices is because budgeted revenue estimates are based on the Henry Hub natural gas price in the United States, even though less than 10 percent of our LNG exports go to the United States. We now have more varied LNG export markets which consist of South America, Europe, the Middle East and Asia. This means our LNG is sold at different prices in these various markets. Government's natural gas revenue is based on the net back price for LNG at Point Fortin, which is an average price tallied from the various markets for our LNG exports. The Henry Hub natural gas price is currently trading at US\$4.00 per million British thermal units, that is, 45 percent above the budgeted natural gas price. The netback price for LNG at Point Fortin is currently around US\$5.50 per million British thermal units, which is double the budgeted natural gas price. However, in some regions, such as Asia and Europe, natural gas prices are indexed to oil and can move in tandem with movements in oil prices. Even so, Central Bank estimates the netback price for LNG at Point Fortin would have to fall by 50 percent for an extended period of time to significantly compress energy revenues. Therefore, the bottom line is this: falling oil prices should not have an immediate impact on our budget, as 70 percent of our revenue comes from the sale of natural gas-based exports which are currently trading at double the budgeted natural gas price.

The third reason we should avoid hysteria over falling oil prices is that the Minister of Finance and the Economy has several fiscal options he can exercise to adjust to a shortfall in energy revenues. Last Friday, Minister Howai, indicated his plan of action would be to slash \$1.3 billion in expenditure across Ministries. The Minister also has the option to access the Heritage and Stabilization Fund to partly finance budgetary shortfalls. However, as I've advised Government, the current situation does not warrant withdrawals from the HSF, and further expenditure cuts should be made if shortfalls in energy revenues persist for an extended period of time.

We have lived with oil price volatility for more than 100 years. Trinidad and Tobago survived the collapse of oil prices in the mid-1980s and, more recently, in 2008 when oil prices dropped by more than 30 percent. What is important, as I have advised the Minister of Finance and the Economy, is the need to exercise prudence when making choices to stabilize the fiscal position.

I would now like to turn to another murky matter that has grabbed headlines for most of the year – foreign exchange, but not just foreign exchange, everyone's needs for precious US currency being unfulfilled, from the vacationer wanting US\$500, to you, the business community being unable to pay for goods, and seeing your credit standing being affected. Foreign exchange has been turned into a murky matter by some with agendas and others who pretend to be ignorant about how our system works.

I'm sure when the business reporters write the 2014 year in review, they will probably say the so called, "foreign exchange shortage" is the business story of the year and perhaps it is – but there are always three sides to a story... yours, mine and the truth... and may be after a year and more, some of you will see the truth today.

Let's start at the beginning. As banker to the Government, we receive the country's revenue from the energy sector through the taxes energy companies are required to pay every quarter in US dollars. That money forms most of the country's "Official Reserves". Central Bank invests the reserves and we use the interest income we make from those investments to fund the operations of the Bank itself. Central Bank is not funded by the taxpayer, and we do not receive funding from the Government. In fact, it is the other way around. At the end of the fiscal year, we send our surplus to Government. We also use the reserves to service Government's external debt payments and to sell foreign exchange to the banking system to meet shortfalls in supply. Through our sales of US to the financial system we foster orderly conditions in the foreign exchange market, thereby maintaining exchange rate stability.

As you are well aware, demand for foreign exchange from the business community and the public is perennially high, but supplies come to the market at discrete intervals, usually when energy sector companies convert foreign exchange with the banking system to pay local bills. So foreign exchange supplies to the country come in two ways:

1. Directly to the Central Bank when energy companies pay their quarterly taxes in US dollars and;
2. When energy companies convert US dollars through the banking system year-round to meet local commitments.

However, demand is always higher than supply and these gaps result in shortfalls in the system and it is at these points when Central Bank steps in to meet the shortfalls by selling foreign exchange from our stock of official reserves. Therefore, Central Bank only enters the system to meet shortfalls in foreign exchange supply, not to provide the entire supply to the financial system. Right now we account for just over 25 percent of the total foreign exchange supply while the money that comes directly from the energy companies account for the rest.

What then, based on this structure, has created all the noise in the past year? There was a time when shortfalls would occur seasonally, close to Christmas and the hectic August travel period. Over the last two decades, demand for foreign exchange not only expanded but its composition has also changed to reflect new patterns of consumer spending, for example,

use of credit cards for making online payments. Today is now known as “Cyber-Monday” in the United States and many locals will flood US retailers’ websites from the comfort and warmth of their homes in Trinidad and Tobago thanks to the Internet, credit cards and US delivery addresses.

Foreign credit card purchases devoured US\$570 million for the year so far. That excludes today’s Cyber-Monday sales and upcoming Christmas purchases. Last year, foreign credit card payments consumed US\$530 million. That is more than US\$1 billion spent foreign credit card purchases in just two years. Commercial banks must meet these credit card payments before they meet any other foreign exchange demand.

That’s one source of demand, then there’s that double-digit growth in sales of new cars, many of which are higher-end luxury vehicles. For the year so far, we’ve spent US\$205 million on purchases of new cars; last year that figure was US\$340 million. That is nearly US\$750 million on purchases of new cars in two years.

Foreign currency deposits are another source of foreign exchange demand. Currently, we have US\$ 3.3 billion dollars in foreign currency deposits in the banking system.

Here’s where it gets interesting, and the foreign exchange story gets a bit murkier. There are many business leaders who often give their opinions freely on foreign exchange, many go the media and have been extremely vocal on the matter. Many businesses have legitimate requests for foreign exchange and we acknowledge your requests are not always met on time, and it is for this reason Central Bank has taken US\$1.7 billion dollars from our reserves for the year so far to help meet your unsatisfied demand. However, we’ve noticed a trend, where businesses make noise for foreign exchange to pay bills for trade-related purposes and actively lobby the authorized dealers and Central Bank for US dollars. When the money is provided, the funds are promptly deposited in their foreign currency account and left unused and the noise about not being able to get money for business continues. I do have one tip for businesses trying to get foreign exchange; it helps if you don’t conduct business with companies with terrorist links as we have strict laws on Anti-Money Laundering and Combatting the Financing of Terrorism.

As I indicated before, Central Bank steps into the market to meet the shortfall in foreign exchange supply and that presently accounts for just over 25 percent of total supply. So why can’t we supply 50 percent or 80 percent, or even all? Why must we ensure that we have enough official reserves put aside?

Well...let me ask you this...What if the global financial crisis goes on for another five years? What if the Fed raises interest rates faster and more than expected next year and causes tremendous volatility in global currency, stock and bond markets? What if the Ebola virus spreads to the Caribbean region? When we factor in the chance of these external events happening, we have to ensure we have enough official reserves as insurance just in case something does happen.

The plan is to ensure we don’t deplete these reserves, as we once did in the late 1980s, because it took us 30 years to finally reach to today’s US\$11 billion. And yes, this US\$11 billion includes US\$1.175 billion from proceeds from the sale of MHTL. In benchmarking, we have just over one year’s worth of official reserves. This means if I took all the official reserves and gave it to the business community, you would actually be able to buy everything you need for a year. Is that enough?

Should I keep using the country’s official reserves to ensure every commercial activity that demands foreign exchange gets it from Central Bank? I will not be the Governor who ran down the country’s reserves to make everyone happy. I prefer to continue to be the Governor, who all armchair economists say disrupted the foreign exchange market, because of improvements I know will benefit you and the entire country in the long run, than the one who tried to get everyone to like him and make friends by playing loose and fast with the country’s foreign exchange reserves.

Central bank's monetary policy actions

I now turn to Central Bank's monetary policy actions.

At its November 2014 meeting, the Monetary Policy Committee (MPC) of Central Bank resolved to again increase the "Repo" rate by another 25 basis points to 3 ¼ percent. This is the second hike in just two months, after holding the Repo rate at an historical low for nearly two years. The MPC is sending a signal it believes higher interest rates are now necessary in our financial system to mitigate the disruptive effects of higher portfolio capital outflows and to pre-empt a potential rise in inflationary pressures. The MPC based its decision to start a gradual withdrawal of the accommodative monetary stance of the past four years on three main factors.

First, forward guidance from the US Fed has altered market expectations about the time frame for the end of quantitative easing and the start to an increase in the Fed funds rate. As indicated before, the US Fed ended its quantitative easing programme in October 2014 and is expected to gradually increase its policy interest rate from around summer of 2015. At current interest rates, US dollar assets are more attractive to TT dollar assets, prompting movements of portfolio capital in search of higher yields. We need to stay well ahead of the curve if we are to enhance the appeal of TT dollar assets.

Second, headline inflation is accelerating, reaching just shy of 10 percent double-digit territory in October 2014, up from 3 percent at the start of the year. This was the highest headline inflation rate since July 2012, when I assumed office as Governor. The pick-up in headline inflation is mainly due to an escalation in food price inflation, which is currently hitting almost 20 percent. Rising food prices reflect lower domestic agricultural output partly due to the cessation of planting by Caroni Green Limited as a consequence of its prolonged organizational restructuring. With the recent heavy rainfall and flooding in some parts of Trinidad, we expect further increases in food crop prices. Looking ahead, higher public spending through the expansionary 2014/2015 Budget is already adding to elevated liquidity levels (currently nearly \$8 billion) and may further push up core inflationary pressures.

Third, the non-energy sector has delivered fairly respectable growth for 14 consecutive quarters to September 2014 and the near-term outlook is for continued steady performance in non-energy output. This suggests the non-energy sector is developing enough resilience to withstand a gradual increase in interest rates. In addition, growth is strengthening in the United States, and this augurs for CARICOM countries which are the major market for our non-energy exports.

Apart from increases to the Repo rate, Central Bank has been very active over the past year managing excess liquidity. The main source of this liquidity arises from financing Government's net domestic budget deficit. For the year-to-date, net domestic fiscal injections added over \$11 billion into the system, while the maturity of two Central Government bonds previously issued for liquidity absorption purposes, also returned approximately \$1.5 billion into the system.

In order to effectively manage liquidity levels, the Bank utilized several tools at its disposal. Given the increased limits under the Treasury Bills and Notes Acts, over the period January – October 2014 the Central Bank intensified its use of open market operations and withdrew \$10.7 billion from the banking system. Of this amount, \$7 ½ billion in open market securities were issued to sterilize or lock away the liquidity arising from an extraordinary, one-off purchase of US\$1.175 billion in foreign exchange from a bank.

In addition, Central Bank rolled over three commercial banks' fixed deposits totalling \$4.5 billion and facilitated the issue of a \$1 billion liquidity sterilization Treasury bond in June 2014. Further, Central Bank sales of foreign exchange to authorized dealers indirectly removed \$9.1 billion from the system over the review period.

The Bank plans to re-open the un-issued portion (\$440 million) of the \$1 billion liquidity Treasury bond issued in August 2013 as well as use other liquidity absorption measures to rein in excess liquidity in coming months.

Short-term prospects

I would like to turn now to the outlook for 2015.

We are facing weaker global growth prospects with significant downside risks. Perhaps the most immediate downside risk to Trinidad and Tobago stems from market volatility about the future path of US monetary policy. Against this backdrop, Central Bank's outlook is circumspect for 2015.

Several factors support central bank's 2015 outlook:

- First, we expect energy production to return to more reasonable levels next year, providing a firmer boost to economic growth. This, of course, is dependent on many factors. So far, both bpTT and BGTT, the two main gas producers, have given no indication of any major planned supply disruptions. We expect some resolution to the on-going negotiation of gas supply contracts. In addition, oil production appears to have stabilized driven by Petrotrin and the smaller, independent producers.
- Second, we expect the non-energy sector to maintain its respectable growth performance. With general elections due in 2015, construction activity is likely to remain strong even if Government slows down its heavy capital expenditure programme which plays a critical path in providing fiscal stimulus to the economy. This, combined with other projects undertaken by the private sector, is expected to further boost non-energy activity.
- Third, we are guarded in our 2015 outlook, as results from the third Business Confidence Survey, conducted by Central Bank and Arthur Lok Jack Graduate School of Business, once again point to cautious optimism among the local business community. Just over half of respondents anticipate improvements in the local economy over the coming year, while 65 percent expect their financial outlook to improve over the next 12 months. Businesses in Central Trinidad and in Tobago remained the most confident about the business and economic outlook in the short-term.

Conclusion

As I conclude, I know many of you will leave here today with the ½ percent growth in our economy as the number on your mind, and the projected growth that didn't happen. What you need to contemplate as you walk out of here is this: the biggest threat to our economy's growth prospects at this time will not come from the weak performance of the energy sector nor will it come from falling oil prices. The peril that has the potential to test us the most in 2015 will come from those storm clouds gathering over increases in US interest rates. Two consecutive increases in the Repo rate by Central Bank will mean higher lending rates. However, it is difficult and painful action needed to shield the Trinidad and Tobago economy from the murky weather ahead. Central Bank will continue to make the difficult and tough choices to help keep our economic house in order.

I thank you.