# Ewart S Williams: Inflation threats, foreign exchange market and challenges in the stock market

Luncheon address by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Annual General Meeting of the Trinidad and Tobago Chamber of Industry and Commerce, Port of Spain, 29 March 2006.

*      *      *

I am pleased to be able to join you at your Annual General Meeting and to be given this opportunity to say a few words to this important gathering. In your letter of invitation, you indicated some areas in which you felt it might be useful for us to focus our attention today. If I am to judge by your suggestions, then it would appear that we share many of the same concerns.

As you requested, I will focus on the current **inflation threat**, **the increasing pressures in the foreign exchange market,** and **the challenges we face in the stock market**. I would, however, like to couch the discussion in terms of the recent evolution of the non-energy sector and its implications for long-term sustainability.

First, some observations on our current economic situation.

By all the conventional yardsticks, the present state of and prospects for the economy are exceptionally favourable:

- We are now into our second decade of continuous strong growth.
- Unemployment is at historically low levels.
- Oil prices are high and the projection is for them to remain so over the medium term.
- Our external indicators, the current account surplus, debt ratios and foreign reserve levels are strong.
- Our financial system is robust and well capitalized.

While this picture is very reassuring, there are still concerns. An ambitious public investment programme is stretching our absorptive capacity to the limit and this presents challenges for macro-economic stability.

A second area of concern is sustainability and the extent to which we are leveraging the present energy windfall to create a strong diversified economy.

There is no doubt that we are doing an excellent job at expanding and diversifying the energy sector. However, we are still waiting to see the non-energy sector develop a platform to generate its own dynamic. Growth in this sector has averaged 4.5 percent a year over the past three to four years but the main drivers have been the construction sector, distribution and financial services. While this growth has contributed to the expansion of employment it depends heavily on government spending and the foreign exchange generated by the energy sector.

If we are to progress towards sustainable diversification of our economy, we must continue to strengthen the links between the energy sector and the onshore economy, and at the same time develop new foreign exchange earning activities, be they in services or in the manufacturing sector.

About a decade ago we seemed to be well on the way to creating a platform for a **strong non-energy economy**. You will all recall that coming out of the collapse of the first oil boom, successive governments introduced a range of macro-economic and structural reforms that set the stage for the current economic expansion. Specifically, trade liberalization forced several manufacturers to re-tool and modernize their operations to compete in a more open environment.

The response of our manufacturing sector remains to this day a shining example of its ability to adapt to new challenges and opportunities, a point strikingly borne out by our dominance in the CARICOM market.

Some of our manufacturers went even further afield such that we can point to some international success stories in soft drinks, alcoholic beverages and [chocolates – perhaps there are more].

Basically, however, the relatively small size of our regional market has limited our export expansion. Under these circumstances, it would have seemed a logical next step to turn in the direction of Latin America. But this strategy has not been pursued as vigorously as expected. The slow progress of the FTAA negotiations may also further constrain the ability of our firms to penetrate extra-regional markets.

We are now seeing from the private sector **a rather interesting response to our current oil boom**.

What are the main elements of this response?

(i) A couple of our large firms have made a foray in the downstream energy sector (and this is as it should be if more of the returns from our natural resource wealth are to accrue to the national economy).

(ii) More generally, however, the increase in private investment in the non-energy sector has been disproportionately in nontradeables – in services directed to the domestic market rather than to exports – in shopping malls and **in other kinds of** real estate.

(iii) Our private sector has also developed a tremendous appetite for foreign portfolio investment (and I would return to this later).

In short, in the midst of this current oil boom, ladies and gentlemen, our export manufacturing sector seems to have lost its dynamism to the non-tradeable service sector (real estate, distribution and retail franchising) and to increased portfolio investment.

Ladies and gentlemen, this new phenomenon is clearly reflected in the current statistical indicators. In the years immediately following trade and financial liberalization (1994-1997), annual growth in manufactured exports averaged about 16 per cent. Since 2001, this growth has leveled off markedly.

Since 2000, employment in the manufacturing sector has stagnated at around 10 per cent in the face of strong employment growth in other areas of the non-energy economy such as construction (16 per cent) and the distributive trades (18 per cent).

The indicators are clear – a slowdown in manufacturing exports and employment, with growth and employment gains being led by construction and distribution.

While we may be able to afford this inward looking pattern of development now, because of the availability of foreign exchange, it is not very efficient and more importantly, **it is clearly unsustainable and will come to a halt once the energy boom subsides as it certainly will.**

Incidentally, several reasons have been advanced for this new phenomenon:

- Some say, for instance, that having dominated the CARICOM export market, our export sector has had difficulty making the adaptations (technical and cultural) needed to penetrate extra-regional markets (the US, Europe, Central and South America).
- Some analysts suggest that given the current buoyancy of the economy, it is so easy to make money in the domestic market that there is no appetite to incur additional costs and risks in penetrating new export markets.
- I have also heard the argument that our manufacturers lack the size to penetrate extra-regional markets and to compete with the export push from China and India. But even if this is so, why haven't we been able to set up strategic alliances with international manufacturers to capture a share of the burgeoning outsourcing market?

We could discuss this sustainability problem at another time. I would now like to focus on three immediate challenges: **maintaining low inflation**; **our foreign exchange market**; and **our local stock market**.

During 2005, there was global concern about rising inflation.

In the US, for instance, headline inflation reached as high as 4.5 per cent in September 2005, the highest rate in many years.

With sluggish domestic demand and slow growth in the Eurozone, inflation has remained subdued at about 2.3 per cent.

In the Caribbean, inflation in Barbados picked up from 1.6 per cent in 2003 to 3.2 per cent in 2005.

Jamaica saw an increase in inflation from 10.3 per cent in 2003 to 15.3 per cent while in Guyana, inflation increased from 5.0 per cent in 2003 to 6.0 per cent in 2005.

Here in Trinidad and Tobago, against a background of very robust economic growth, estimated at 7 per cent, inflation rose from 3.8 per cent in 2003 to 7.0 per cent in 2005.

In most of the other economies, the main driver of inflation was the substantial increase in international oil prices. In Trinidad and Tobago it was the sharp increase in food prices – a phenomenal 24 per cent increase in 2005 (year-on-year).

Food prices have always registered (inexplicably) strong increases in Trinidad and Tobago – an average of 12 percent or so in the period 1995-2000. This climbed to 14 percent in 2001-2004 and to a whopping 24 percent in 2005. Analyzing the index shows a significant jump in the prices of fruits and vegetables, influenced no doubt by the severe floods in 2004 and 2005 which worsened an otherwise structural decline in domestic agricultural production. **The continued strong increase in food prices at the supermarket level is perhaps more difficult to explain given trade liberalization**. It may have to do with the oligopolistic structure of the distribution sector which facilitates high profit margins.

From my vantage point, more than the current level of inflation, I am concerned about indications of growing inflationary psychology. And the signs are there. For example, (i) even before it has stopped raining you can bet on hearing some knowledgeable analyst predict a hefty rise in fruit and vegetable prices; (ii) similarly, the slightest congestion on the ports also brings a prediction of large price increases – even though port charges may be a miniscule share of the product prices.

Drawing from the experience of the last oil boom, an even greater concern is the potential for intensified wage pressures. In this regard, I hope I am misreading the current industrial relations climate.

I would now like to make some comments on the recent developments in the foreign exchange market (in which the Chamber has, not unexpectedly, an intense interest).

Trinidad and Tobago adopted a liberalized foreign exchange regime in 1993. At that time, we liberalized both current and capital transactions (unlike several IMF members, who still maintain some controls on capital transactions). When we liberalized it was recognized that given the small market and the concentration in the financial system, **we could not have a fully market-determined system, because of the potential for exchange rate volatility and overshooting**. We realized that while the system should provide for greater flexibility, it needed to be carefully managed requiring collaboration between all the stakeholders – Central Bank, the commercial banks and the public and private sectors.

One element of this collaboration was the establishment of the “sharing mechanism” whereby foreign exchange sales by the energy companies were shared among the financial institutions. Another was agreement on the pace at which any given bank could adjust the exchange rate - the idea was to limit price competition for foreign exchange. **The financial institutions admit that these mechanisms have worked well, contributing to the stability of the market**.

As you know, pressures on the foreign exchange market intensified in 2005. The main factors behind these pressures were:

- the rapid increase in private incomes leading to buoyant import demand;
- increases in government expenditure on capital projects, some of which have a high import content; and
- a significant increase in capital outflows for asset acquisition, purchase of securities issued by regional sovereigns andcorporations and a rise in portfolio outflows, including foreign currency denominated mutual funds.

Some highlights of 2005 are:

- Out of total purchases by the commercial banks of US$2.6 billion, **60 per cent came from the energy sector**. If we include the sales by the Central Bank, **the energy sector accounts for closer to 70 per cent of the foreign exchange** intermediated in the foreign exchange market.

- Of total foreign exchange sales of US$3.6 billion, about 80 per cent were for current transactions (trade and services) and close to 20 per cent (about US$ 650 million) were for the capital transactions.

In 2005, to meet the increased foreign exchange demand, the Central Bank sold **US$670 million** compared with US$386 million the previous year.

In the first quarter of 2006, the Central Bank has sold US$370 million to meet shortfalls in the market (more than half of last year's figure in one quarter). The Bank has discerned that over this period **there has been a decline in conversions of foreign exchange by the non-energy sector**, possibly signaling a delay in repatriation of export earnings. Moreover, when we examine the demands reported by the commercial banks, we notice **a tendency for some clients to make multiple and repeated requests to several banks**. It is clear that **some clients are prepaying bills and there is evidence of foreign exchange hoarding**. **These practices worsen market imbalances**.

Ladies and gentlemen, foreign exchange is a national resource coming largely from our national patrimony (the energy sector). For most developing countries, foreign exchange is a **major developmental constraint**. For Trinidad and Tobago, the constraint has been temporarily eased **but it is there** and **it behoves us to use foreign exchange in a way that best benefits the economy and facilitates sustainable development**.

There is a limit to which this economy could sustain the current level of foreign investments, overseas land purchases and the like, and still meet our normal consumer and production needs. Of course, **you could ration through the exchange rate but in a small market like ours with institutional concentration**; this carries serious volatility risks. Notwithstanding liberalization, we need to carefully manage the foreign exchange market.

The best way of doing this is through a **proper balance of market discipline and stakeholder collaboration**. All the stakeholders need to play a part. Specifically:

- the fiscal authorities need to reduce the non-energy fiscal deficit to help contain excess liquidity;
- **the Central Bank** needs to intensify liquidity absorption (and this would imply higher interest rates);
- **the Bank** is committed to increasing foreign exchange sales subject to the maintenance of an adequate level of official reserves (between 6 and 7 months imports); and
- **the private sector and the banks** need to play their part by recognizing the priority to be given to trade and smaller foreign exchange transactions, **even if it means occasionally queuing large capital market transactions**.

It is certainly not in the country's best interest **for banks to have to put limits on foreign exchange sales for trade and service transactions** while **investors amass large sums for offshore portfolio investments.**

**Some closing comments on the Stock Market …**

One reason advanced for the increased outflow of financial capital is **the shortage of investment opportunities** locally. The government securities market has been expanded and with a new auction system has been made more transparent.

There is no doubt that the stock market has not expanded as envisaged, either in terms of the number or range of offerings. **But this is another area where collaboration is essential**. To me it is not enough simply to say that the Government should seek to privatize certain assets through the stock exchange, **as indeed they should**. The private sector can also contribute more to expanding stock market activity **through debt issues and through new listings**. I know this could mean a dilution of control and having to adhere to new disclosure requirements, but these are the inconveniences that we would need to face in order to make **that next leap towards development**.

The stock market displayed robust growth between 2002 and 2004. During this period, market capitalization increased by 50 percent on average, as investors switched from low yielding money market investments to equity investments. Although the market continued to register gains during the first half of 2005, it weakened considerably thereafter. Many reasons have been advanced to explain this reversal in the fortunes of the stock market. Among these is the rising trend in interest rates which has made money market instruments relatively more attractive. Many analysts also believe that given the earlier rapid increase in stock prices, many stocks had perhaps become overvalued and the market was due for some form of a correction. There has also been some rebalancing of portfolios by institutional investors who have reduced holdings of equity in their portfolios.

**Another issue of interest with regard to the Stock Market** …

Although prudential guidelines require that direct investments in equities by pension funds should not exceed 50 per cent of their portfolios, many pension plans find themselves in excess of this limit as a result of the strong performance of the stock market in recent years. When one takes into account their indirect holdings of equities through their investments in mutual funds, it is estimated that as much as 64 per cent of some pension plans' portfolios is exposed to the volatility of the equity market. **Such a high level of exposure brings with it certain inherent risks, especially in our small market which could be very volatile**. We have estimated for instance, that in the current scenario, a 30 per cent reduction in the stock market could reduce the portfolio of some pension funds by about 10 per cent. **As regulator**, we have a responsibility to ensure that pension funds exercise good prudential risk management. Obviously, we need to consider a reasonable transition period to minimize the impact on the stock market.

Ladies and gentlemen, I have taken (perhaps too much) time to make the fundamental point that we have an excellent opportunity to transform our economy through the establishment of a strong, exportbased non-energy sector. My thesis is that if we are to achieve this, all stakeholders need to work in close collaboration. In a small, closely-knit society, as ours, market mechanisms alone are unlikely to produce the desired results. The experience of the successful Asian economies has shown that there is room for competition **within an agreed framework that puts social before private interests** and long-run sustainability before short-term gains.

We have done this before and it has proven to be successful. Let's begin to do it again.