Ewart S Williams: Trinidad and Tobago – state of the economy and short-term prospects

Remarks by Mr Ewart S Williams, Governor of the Central Bank of Trinidad and Tobago, at the Monetary Policy Report media conference, Port-of-Spain, 17 November 2008.

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Good morning, ladies and gentlemen and thank you for joining us. Before I discuss today's Monetary Policy Report, which reflects the Central Bank's latest thinking on the economy, I would like to say a few words about the global financial crisis.

The honest truth is that it is difficult to make an informed assessment about the state of the crisis since each day brings more depressing news.

There would seem to be sufficient evidence to suggest that the risk of a total melt-down of the world's financial system has receded somewhat, though all the accompanying ills are still with us.

While solvency concerns have eased in the light of official commitments to use public funds to recapitalize financial institutions, lingering uncertainty has impeded the proper functioning of money and capital markets.

Thus, we are seeing unprecedented volatility in the world's major equity markets; liquidity preference, risk aversion, and bank spreads remain at elevated levels.

Perhaps the big legacy of the financial crisis may be a global recession. The US is now in recession; the UK has been in recession for a few months now; and on Friday, the Euro zone conceded that recession had arrived.

(One last word on the international economy)

Contagion has finally reached developing and emerging market economies, all of which will experience slowdowns. Even so, the entire increase in global growth in 2009 is expected to come from these economies. The industrialized economies as a group are projected to decline by as much as 1 per cent. Emerging and developing economies are projected to grow by around 5 per cent (most of it from China and India).

It is not surprising therefore that the historic talks held in Washington DC over the weekend (some called it Bretton Woods II), were not among the G7 or G8 (as is the custom) but among a broader group called the G20 countries.

Many observers see this as a clear recognition that the world could not get out of its present predicament without, China, India, Saudi Arabia, Brazil, and a host of others… they are providing the growth and they have reserves to pull even the developed countries out of the present dilemma.

We will have to wait and see whether this historic power shift is temporary or permanent.

Now what is the state of the economy of **Trinidad and Tobago?**

As indicated in the **Overview**, which we handed out this morning, so far, the contagion is coming largely through the sharp decline in oil and gas prices and falling demand for our energy-based products – iron and steel and petro-chemicals.

- The Central Bank's projection is for a slowing of real GDP growth to 3.5 per cent in 2008, down from 5.5 per cent in 2007. Most of the slowdown is coming from the energy sector.

- As the non-energy sector continues to do relatively well, unemployment remains low at 4.6 per cent with persistent labour shortages, mainly in construction and manufacturing.
- Since the last MPR in April, **headline inflation** has accelerated, from 9.3 per cent (year-on-year) to 14.8 per cent in September. **Food inflation** has risen from an already high 20 per cent to a mind-boggling 35 per cent in September. (If we are looking for some comfort, the last data we have has food inflation at 16 per cent in Barbados and 34 per cent in Jamaica and Suriname).
- **Core inflation i.e. excluding food** has risen from around 4 per cent as at end-2007 to 6.2 per cent in September 2008. (For us, at the Bank, **core inflation** is a good measure of underlying inflationary pressures – and we would like to see it at around 2-3 per cent).
- Not surprisingly, the report identifies **the main drivers of inflation** as:
  - (i) **the record rise in international food prices** that shocked the entire world from around the second half of last year, through mid-2008 (and you know all the reasons ; high oil prices, the diversion of agricultural lands to ethanol, climate change etc).
  - (ii) **Insufficiency of domestic agricultural production** (and persistent crop damage resulting from floods).
  - (iii) **Our expansionary fiscal stance** as we seek to pursue rapid development and to relieve the constraints being posed by declining spare capacity
  - (iv) **Rapid bank credit expansion**, fuelled by buoyant liquidity conditions; and
  - (v) **High inflation expectations** (which has become a major issue).

In terms of policy responses, during the fiscal year ended September 2008, while **fiscal policy** may have resulted in a larger overall surplus, permitting an increase in transfers to the HSF, it made little dent in **the non-energy fiscal deficit** which currently stands at 14.7 per cent of GDP. (The report tries to explain why the non-energy fiscal deficit is important from the standpoint of inflationary pressure).

Throughout 2008, the Central Bank has sought to maintain **a restrictive monetary stance**, utilizing all the instruments in its arsenal – special sterilization bonds, open market instruments, reserve requirements, the repo rate – with mixed results.

All these measures tend to result in higher interest rates, which can affect business activity, in particular small businesses (which could be a problem) and mortgage rates (which could cause severe hardships, including for people who can least afford).

The message here is that **excessive dependence on monetary policy to deal with inflation carries real risks and that the only way of reducing inflation, without severe consequences for interest rates is by having a better balance between fiscal and monetary policy i.e. sharing the burden between the government and the private sector.**

What are the short term prospects?

To say the least the current international crisis and in particular, the steady decline in energy prices, are giving rise to much uncertainty in our domestic economy. This nervousness is being reflected in several ways:

- An incipient recovery in the stock market has petered out and as in the US, investors are now playing safe.

- Businesses are now becoming quite concerned about the cost funding, about the impact of any budget adjustments on domestic demand, and about declining export demand in CARICOM.
- There are clear signs that the real estate market is softening (that's a good thing) and that housing construction activity may have peaked (both in the public and private sector); and
- Consumer confidence in the economy also seems to be weakening.

Against this background, our projection is for **real GDP to decline further in 2009** to about 2 per cent. The slowdown will come both from the energy and non-energy sectors and could have some impact on employment, though any employment reduction is not expected to be major.

(**One thing that we need to be clear about is that unemployment is unlikely to remain forever at 4.6 per cent but will fluctuate (hopefully in a narrow band) in line with business conditions).**

For several governments (the US, the UK, the Euro zone and many others worldwide) the overriding risk is of a major slowdown and all that implies (high unemployment etc.). Further, as these economies do not see the inflation risk as serious and imminent, they are taking expansionary monetary and fiscal action.

In the Bank's view, for Trinidad and Tobago, with inflation already at 14.8 per cent, **inflation reduction should be priority number one.** In the **Overview,** we make the point that a quick return to single-digit inflation is critical for reversing inflation expectations and bringing inflation down to 6-7 per cent in the medium term.

One cannot have sustained growth and improve the quality of life of the population until inflation is brought under control.

The downward trend in global food prices will help to reduce food price inflation; expected increases in domestic agricultural production and increased food imports from Guyana should also help to bring down food prices.

The Government has indicated that it will respond to projected reduction in energy tax collections by trimming expenditures. The Central Bank is committed to tightening the monetary stance as required.

Dealing with wage demands could present a challenge. High inflation and in particular, high food price inflation have seriously eroded the real incomes of workers and understandably this is going to be reflected in their wage demands. How we deal with this will determine whether we achieve a reduction in inflation or whether we face the risk of a wage/price spiral.

We continue to believe that the best way of resolving this is through dialogue (a social compact) between the major stakeholders Finally, the MPR touches on a worst-case scenario (hopefully, highly unlikely) in which oil prices fall below US$40 per barrel with corresponding declines in gas prices. We argue that our economy is in a better position now to withstand such a worst case scenario (given our level of reserves, low external debt, the HSF etc.). Obviously addressing such a worst case scenario would call for major adjustment in both the public and private sectors.

Thank you Ladies and Gentlemen.