INTERNATIONAL MONETARY FUND

Press Statement Issued by the IMF Mission for the 2008 Article IV Consultation Discussions with Trinidad and Tobago

November 17, 2008

An IMF mission headed by Christina Daseking, Deputy Division Chief in the Western Hemisphere Department, issued the following statement at the end of its discussions in Port of Spain:

"An IMF team visited Port of Spain to discuss economic and financial developments, policies, and prospects, as part of its routine annual consultation with Trinidad and Tobago. The mission received excellent cooperation and benefited from open and fruitful discussions with government and central bank officials, as well as representatives of the opposition, the private sector, and labor unions.

"Benefiting from a booming energy sector, Trinidad and Tobago has achieved an impressive improvement in economic indicators. During 2002–07, real GDP growth averaged 9 percent; per capita income doubled in U.S. dollar terms; both the unemployment rate and the public debt ratio were halved; and the country became a net external creditor, with one of the strongest credit ratings in the region. At the same time, record high energy prices have fueled government spending, leading to capacity constraints in the non-energy sector and, together with rising food prices, to double-digit inflation.

"Trinidad and Tobago is better placed than many countries to weather the international financial crisis, but is not immune from contagion. External vulnerability is low, as a result of large international reserves and low debt ratios. Moreover, the banking sector has entered the period of global turmoil from a position of strength, being well capitalized, liquid, and profitable, and funded mainly through domestic deposits and equity, as opposed to external borrowing. This has limited direct spillovers and disruptions, thus far, and contains the risk of liquidity shocks transmitted through foreign parent banks, should these come under stress. In the event of a further sharp fall in energy and asset prices, however, and a more severe global slowdown, risks could arise from exposures of large and complex financial conglomerates that operate across the region and deteriorating balance sheets, including from a possible rise in non-performing loans.

"Economic growth is projected to decline in the face of a deteriorating external environment. Recessions in advanced economies, their spillovers to the tourism-dependent economies of the region, and sharply lower prices for energy products are projected to slow growth to 3½ percent in 2008 and 2 percent in 2009. This, together with falling international food prices, should help dampen domestic price pressures, but the base effect of this year's food price shock, in combination with still tight capacity constraints and labor market conditions, is projected to limit the decline in headline inflation to 7½ percent in 2009, down from 11¾ percent this year. At the same time, the external current account surplus is projected to decline by 13 percentage points to about 15 percent of GDP, in response to falling energy export earnings, while the central government balance would move into a deficit of about 2 percent of GDP under current budget plans. These projections, however, are subject to an unusually high degree of uncertainty given the unsettled global outlook and volatile commodity prices.

"The main policy challenges are to prepare for the risk of contagion and preserve macroeconomic stability in the face of declining energy revenues and still high inflation. The most pressing need is to prepare for the possibility of more severe spillovers from the global financial crisis by strengthening the crisis-response framework and developing contingencies measures. At the same time, the government needs to safeguard fiscal and external sustainability in the face of falling energy revenues, while credibly reducing inflationary pressures to prevent harmful second-round effects, just at a time when the external environment is deteriorating dramatically.

"Notwithstanding ample liquidity up to now, the authorities need to identify and be ready to implement measures in the event of disruptions in the financial system. While interbank markets have not experienced noticeable difficulties, recent experience in other countries has shown that high liquidity in the system is no guarantee for a smooth functioning of credit markets, should individual institutions become exposed. The mission, therefore, encourages the Central Bank of Trinidad and Tobago (CBTT) to continue monitoring the market situation closely and be ready to respond promptly to signs of problems in the interbank or foreign exchange markets and lending behavior of banks. This includes the identification of contingency measures to ease and broaden access to central bank liquidity and preserve interbank lending. Besides requesting institutions to conduct stress tests with respect to their most important exposures, the CBTT should also develop in-house capacity for stress testing of financial institutions and accelerate work on a crisis-management plan in conjunction with regional supervisors.

"The deteriorating global environment is also adding urgency to the enactment of improved financial sector legislation and the strengthening of supervisory practices. The mission welcomes the recent passage in the House of Representatives of a new Financial Institutions Act (FIA) whose swift adoption will be crucial to enhance the central bank's ability to supervise the country's complex financial sector and lay the foundation for various follow-up legislation in the areas of insurance, securities, pensions, and credit unions. In implementing the improved framework, the authorities are encouraged to (i) press for changes in conglomerates' holding structures, with a clear separation of financial and non-financial activities; (ii) review risk-management practices and enforce prudential standards on a consolidated basis; and (iii) coordinate closely with regional and international supervisors on the basis of clear home/host country responsibilities.

"Fiscal policy needs to adjust to already lower energy prices and the possibility of a considerable economic slowdown in 2009. Fiscal revenues and trade surpluses are projected to decline significantly as a result of falling energy prices. Thus, even though the government has cushions to weather shocks, spending adjustments are warranted to contain the deterioration in the fiscal position and safeguard sustainability under more difficult circumstances. The mission is encouraged by the government's recent announcement to adjust fiscal spending in the face of lower energy prices, and urges a careful assessment of the entire spectrum of expenditures, with a view of maintaining nominal spending at its FY 2007/08 level. Relative to the 2008/09 budget, this would translate into spending reductions of some TT$3 billion (2 percent of GDP) beyond those resulting from lower fuel subsidies, and would broadly balance the central government accounts under current energy price projections. Moreover, it would give the government room to let automatic stabilizers operate in the event of a sharper decline in energy prices and economic activity in 2009, thereby cushioning the adverse impact on the domestic economy.

"Further policy adjustments will be needed over the medium term to preserve long-term sustainability. Sustainability considerations call for a reduction in the large non-energy deficit to generate adequate savings in the Heritage and Stabilization Fund that would allow the country to benefit permanently from its existing energy wealth. On the basis of current projections, the mission estimates that the non-energy deficit will need to be reduced from about 14½ percent of GDP in FY 2007/08 to 8½ percent by 2012/13—an adjustment of 4 percentage points of GDP beyond the tightening suggested for the current fiscal year. Such policies would avoid a much larger, forced, adjustment in the future, in the context of non-renewable energy resources.

"The government has scope for reducing expenditures, while targeting them more efficiently to support its development objectives. While many public investment projects have generated important benefits, there is a need for:

- a careful prioritization, phasing, and monitoring of projects, combined with an overall streamlining of public sector activities to avoid duplication and inefficiencies;
- a better-targeted approach to social programs, which would also permit more effective support to those in need; and
- more generally, a significant reduction in transfers and subsidies, that have mushroomed in recent years.

The mission recognizes that below-market prices for energy, water, and other inputs provide an avenue for sharing the country's energy wealth more widely with the present population. But they also distort investment and consumption decisions, discourage conservation, and expose firms and households to an inevitably sharper adjustment in the future, when windfall revenues from energy eventually run out. In this light, the recent increase in electricity tariffs and the price of premium gasoline are steps in the right direction and should be built upon by adopting a comprehensive approach to phase out unproductive subsidies over time.

"Monetary policy needs to remain vigilant in balancing the risks of inflation with the prospective slowdown in economic activity. Faced with rising inflation and rapid credit growth in an environment of excess liquidity, the CBTT has rightly tightened policies, applying its entire range of instruments. These measures have been effective in slowing private credit growth to less than 14 percent in August, down from about 20 percent early this year, but will take time to be reflected in inflation rates. While banks still hold ample liquidity, a weaker economic outlook, combined with a prospective tightening of lending standards, should slow credit growth further. Thus, once the absence of second-round effects on inflation is confirmed, the CBTT would have scope to respond to a prospective easing of price pressures and economic activity by reversing the earlier increases in reserve requirements, while managing liquidity flexibly through open market operations. The introduction of additional sterilization paper in the form of treasury bonds is a welcome step to facilitate domestic liquidity management and an effective transmission of repo rates to domestic interest rates.

"The authorities should also consider moving over time to a more flexible exchange rate. The current turbulent times are not right for a fundamental shift in exchange rate policies. However, once global conditions have stabilized, a gradual move to more flexibility could bring important advantages. It would cushion the impact of large swings in the terms of trade; provide an additional tool for managing domestic liquidity and inflation in an environment of volatile energy revenues and capital flows; give impetus to the development of capital and foreign exchange markets; and more generally, discourage the build up of dangerous currency mismatches in private sector balance sheets.

"The mission commends the authorities for their readiness to confront the country's development challenges in a pro-active manner in their Vision 2020. Investments in physical and human capital are important to achieve this vision and develop a diversified, knowledge-based economy before energy resources are depleted. At the same time, the authorities need to guard against three important risks in implementing their strategy:

- macroeconomic instability and competitiveness problems, when spending becomes too large;
- waste and mismanagement, when projects are not carefully prioritized, phased, and monitored; and
- future competitiveness and viability problems, when firms become overly dependent on government support and artificially low energy prices.

The mission's suggested fiscal adjustment measures would help reduce these risks. In addition, a stronger focus by the government on the provision of public goods, and a gradual shift from an active to a facilitating role of the public sector in the domestic economy, may go a long way in stimulating private sector activity and innovation.

"Efforts to improve the overall business climate offer the least costly and most promising approach to promote durable diversification and growth. Global comparisons of competitiveness suggest that Trinidad and Tobago has considerable room to improve its business environment, including in areas such as contract enforcement, property registration, and public service delivery. Here, the envisaged enhancement of ICT-based service provision is an important step in the right direction. Further improvements in the business climate would also buttress the authorities' plans for establishing an International Financial Center (IFC)—the prospects of which may have become more challenging in light of global financial developments. Success will depend on finding the right niches that could also provide links and synergies with existing businesses and expertise. At the same time, a modern regulatory environment and market infrastructure are important requisites, not just for the IFC, but also to promote financial deepening and efficient resource allocation, more generally. In this respect, the mission warmly welcomes the government's efforts to modernize the tax, legal, and regulatory framework.

"On its return to Washington D.C., the team will prepare a staff report that is tentatively scheduled for discussion by the IMF's Executive Board in mid-January, and expected to be published on the IMF's external website, soon thereafter. The mission is grateful to the Government and people of Trinidad and Tobago for their kind hospitality and collaboration."