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Statement by an IMF Mission to Trinidad and Tobago

The following statement was issued today in Port of Spain by Mr. José Fajgenbaum, Deputy Director in the Western Hemisphere Department, and Mr. Max Alier, mission chief for Trinidad and Tobago of the International Monetary Fund (IMF):

"An IMF staff mission visited Port of Spain from July 10-20, 2007 to conduct discussions for the 2007 Article IV Consultation. The discussions covered recent developments and current economic policies, as well as the medium-term economic outlook. The mission received excellent cooperation and benefited from a constructive exchange of views with Ministers Conrad Enill and Christine Sahadeo in the Ministry of Finance, Central Bank Governor Ewart Williams, the Chief Secretary of the Tobago House of Assembly Orville London, the Leader of the Opposition Kamla Persad-Bissessar, other senior officials, and representatives from the private sector and labor unions.

Trinidad and Tobago is rightly aiming at using energy resources to reach ambitious development goals before energy reserves are exhausted. Efforts are focused on creating conditions for the development of a vibrant and sustainable nonenergy sector that can generate strong output growth in the event of a major decline in energy prices and/or ahead of the envisaged depletion of energy resources. Key to this goal is the transformation of the energy wealth into a balanced combination of external financial assets, and physical and human capital. The challenge is to implement a prudent mix of macroeconomic and structural policies, as this is essential to support an orderly and efficient absorption of the increased energy earnings over time. These policies also need to take into account the intergenerational aspects associated with the exploitation of exhaustible resources.

The high economic growth experienced for over a decade has been the result of the important reforms implemented in the 1990s and more recently a buoyant energy sector. Trinidad and Tobago's performance has been remarkable in a regional context and in comparison to other energy producing economies. Despite the temporary reduction in energy output in the early months of the year, the economy is expected to expand at around 6 percent in 2007. The external current account is projected to post another solid surplus and FDI inflows to increase. The fiscal accounts are expected to remain in surplus allowing a further decline in public debt and accumulation of assets in the Heritage and Stabilization Fund (HSF). At the same time, there are indications that the economy is operating at full capacity. Emerging capacity constraints and labor shortages represent a downside risk. Although some capacity constraints can be overcome by importing inputs and through immigration, there is a risk of asset price bubbles emerging, especially in real estate.

Fiscal policy needs to be tightened in response to signs that the economy is operating at full capacity and to help contain inflation pressures. The mission notes the constant efforts by the authorities to contain recurrent expenditures. However, the nonenergy deficit has widened in recent years, to nearly 16 percent of GDP, as a consequence of tax cuts to the nonenergy sector, growing subsidies, and rapidly rising capital expenditure. The mission recommends that, notwithstanding the budget supplementary bill, the government should make every attempt to achieve maximum savings from the current expenditure envelope.

Medium-term fiscal sustainability considerations also call for a tighter fiscal policy stance. Mission estimates indicate that a nonenergy deficit not exceeding 10 percent of current GDP is needed to prevent large policy reversals when energy income declines.[1] Pacing the use of energy resources now would maintain investment and social spending over the medium term, and provide the necessary time to develop further the capacity to evaluate, select, and implement high quality public investment projects. The mission realizes that moving toward such nonenergy target needs to be gradual to avoid disruptions in the economy. The recommended fiscal tightening would ideally be implemented in the context of phasing out the current fuel and utility subsidies while strengthening the social safety net to protect the poorest segments of the population, while preserving capital spending on productive projects. Targeted transfers to poor families could be considered.

Adopting a medium-term fiscal framework (MTF) would facilitate this process and allow a more efficient management of public resources. A MTF would assist in linking the annual budget with medium-term sustainability objectives and long-term development plans. Developing a MTF would bring budgeting procedures closer to good international practice, and provide a solid base to shift the public finance management system from an input orientation to output management. The mission encourages the authorities to adopt a MTF and, as a first step, to publish a fiscal sustainability report along with the FY2007/08 budget. Transparency and accountability in the use of public resources are important to ensure that public policy objectives are attained. In this connection, the mission underscores the need for adequate checks and balances to ensure accountability of the special purpose companies to the government and parliament.

A sound asset and liability management framework is key to efficiently transform energy wealth into financial wealth. The mission welcomes the approval of HSF bill institutionalizing a long-term savings framework, but underscores that disciplined fiscal policies are needed for sovereign wealth funds to be effective. It encourages the authorities to examine successful international experiences as they develop the HSF investment guidelines. An adequate debt management strategy is also an important element of the public finances strategy. The mission

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[1] A similar target for 2010 is envisaged in the Vision 2020-Operational Plan 2007-10.

supports the plan to strengthen the debt management unit at the Ministry of Finance, and the Central Bank's initiatives to promote the development of the local capital market, including a secondary market for government securities.

Significant improvements in monetary policy management have been instrumental in curbing inflation. Strengthened monetary management and better policy coordination with the Ministry of Finance allowed the Central Bank to regain control over liquidity in the system. However, for as long as the nonenergy deficit continues to be large the risk of excess liquidity building up remains a concern. Foreign exchange sales and open market operations continue to be the first line of defense, while continued policy coordination with the Ministry of Finance is crucial to keep liquidity under control. Efforts to improve supply conditions in food markets also contributed to lowering inflationary pressures. The mission supports those efforts and encourages the authorities to keep implementing mechanisms to allow consumers to make informed decisions. However, pressures to introduce price controls should be resisted as such controls are distortionary and usually bypassed. The incipient practice of establishing COLA clauses in wage settlements should be discouraged, as they entrench inflation.

The buoyancy of the energy sector inevitably puts upward pressure on the equilibrium real exchange rate. A tighter fiscal policy stance and further opening the economy within the constraints of CARICOM would limit the real appreciation of the Trinidad and Tobago dollar and its adverse consequences on the competitiveness of nonenergy sectors. Monetary and exchange rate policies can affect whether the adjustment in the real exchange rate occurs through nominal appreciation, or through higher inflation than in trading partners, as has occurred in recent years. In recent years, the real exchange rate as measured by unit labor costs has depreciated. As a result, the industrial sector should be in a condition to absorb a more appreciated currency, provided that wage increases maintain competitiveness.

Success of the government's economic diversification efforts hinges on adequately preparing the economy for the eventual exhaustion of energy resources. Industrial policies could play a useful role to achieve this objective. However, continued efforts are needed to create the conditions for the development of sectors that are viable over the medium term without permanent government subsidies. The current favorable economic conditions create the appropriate conditions to move forward the structural reforms needed to generate the productivity gains necessary to improve the competitiveness of the nonenergy sector. The mission recommends focusing on addressing infrastructure bottlenecks, improving the business environment, intensifying regional integration efforts, and developing human capital. The latter is critical to support long-lasting gains in real wages. Significant progress has been made in the preparation of legislation to strengthen the financial sector regulatory and supervisory frameworks. This legislation is essential to ensure a healthy expansion of this key sector, and to become eventually an international financial center. The mission urges the authorities to attach priority to moving this legislation forward in Parliament.

The IMF mission thanks the Government and the people of Trinidad and Tobago for their warm hospitality and the close collaboration in a spirit of cooperative policy dialogue."