INTERNATIONAL MONETARY FUND

MISSION CONCLUDING STATEMENT

Trinidad and Tobago: Staff Concluding Statement of the 2018 Article IV Mission

July 6, 2018

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV (/external/pubs/ft/aa/aa04.htm) of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

The economy is slowly recovering from a prolonged recession driven by energy supply shocks and low energy prices. With signs of improvement driven by energy sector growth from the second half of 2017, the economy is expected to return to positive growth in 2018 as the recovery takes hold in the non-energy sector. Good progress is being made in implementing fiscal consolidation. As growth gathers pace, policies should focus on completing the fiscal adjustment, while insulating the economy from future commodity price swings within a medium-term fiscal policy framework, and on creating an enabling environment for the non-energy sector as an engine of growth .

The economy shows signs of improvement from the second half of 2017, with return to positive growth expected in 2018 following two years of recession. Real GDP contracted at a slower pace of 2.6 percent in 2017, following the 6.1 percent drop in 2016 driven by energy sector shocks. The strong recovery in gas production in 2017H2 had knock-on effects on downstream industries, while oil production remained largely flat, at a historically low level. The weak non-energy sector dampened the overall growth, reflecting weak activity in construction, financial services, and trade; continued shortage of foreign exchange (FX) and slow implementation of public investment projects weighed on the sector. Headline inflation fell to historic lows of 1.9 percent in 2017 on weak aggregate demand, and further to 1.1 percent y-o-y in April. While remaining at relatively low levels, the unemployment rate rose to 5.3 percent in 2017Q2 from 4.4 percent in 2016Q2 (up from 3.3 percent in 2014Q2), with youth unemployment at an estimated 12 percent in 2017, compared with 7.9 percent in 2014.

Fiscal performance improved, while financial buffers provided a cushion. The fiscal deficit reversed its rising trend of the past 7 years, registering a slightly lower overall deficit in FY2017. Despite higher energy prices, energy-related revenues remained flat, due in part to fiscal incentives. The significant reduction in spending by 2.2 percent of GDP implemented through cuts in spending on transfers and subsidies, goods and services, and capital investment was partly offset by the fall

in non-energy revenues from weak economic activity. Borrowing and one-off sources (from the Heritage and Stabilization Fund (HSF), and asset sales) helped finance the deficit. Central government debt rose to 42 percent of GDP and public debt, including contingent liabilities, reached 61 percent of GDP, approaching the government's soft target of 65 percent. The balance of payments remained weak, with outflows through the financial account offsetting the current account surplus. [1] (file:///C:/Users/GHawkins/OTmp/Trinidad%20and%20Tobago_2018%20CS%20(002).docx) Financial buffers remained substantial, with HSF and sinking-fund assets at 30 percent of GDP and gross FX reserves at 9.4 months of imports at end-2017.

Economic prospects are expected to improve broadly over the medium-term . The economy is projected to grow at a modest pace as energy projects come onstream and the recovery takes hold in the non-energy sector. Near-term growth will likely be led by natural gas production with continued challenges in the oil sector. Gradual recovery in non-energy growth would help stabilize growth at 1.5 percent over the medium term. The fiscal deficit is expected to narrow to an average 4 percent of GDP as energy revenues rise, non-energy revenues recover, and spending falls with improved efficiency of transfers and subsidies. With one-off financing options diminishing over time, central government (public) debt is expected to reach 43 (64) percent of GDP by 2023. Despite projected current account surpluses, gross international reserves would fall over the medium term, though at a slower rate, with continued FX intervention under the current FX regime, absent a further increase in energy prices and a tighter fiscal stance.

The outlook is subject to a number of risks tilted to the downside in the near term. Key risks include lower energy prices, delays in delivering energy-related projects on time, and further disruptions to output, pending completion of the oil and gas tax regime reform. Delays in the implementation of the ongoing fiscal adjustment and persistence of FX shortages may weaken market confidence, and adversely affect the country's funding costs. Tightening of financial conditions could stress balance sheets and undermine the non-energy sector's capacity to import and produce. Rising US rates and further US-dollar appreciation could worsen competitiveness and pressure the currency. A sharp rise in energy prices or implementation of a comprehensive medium-term macroeconomic strategy and supportive structural reforms provide upside risks.

The risks to the outlook call for a comprehensive strategy to support the recovery and safeguard fiscal and external sustainability . The relatively favorable circumstances in 2018 with stronger energy prices and low inflation provide a window of opportunity to establish a medium-term adjustment strategy, to signal determination to resolve the challenges and complete ongoing reforms. The strategy should focus on: (i) completing the adjustment, while insulating the economy from future commodity swings; and (ii) creating an enabling environment for the non-energy sector to be an engine of growth, including through: improved FX access, business-friendly environment, diversification efforts, reduced crime, and growth-friendly, efficiency-enhancing public investments.

Addressing the Imbalances and Strengthening the Fiscal Framework

Higher energy prices provide both an opportunity and a risk to the reforms. The rise in energy prices since 2017 has supported improvements in fiscal and external balances and the authorities' ongoing fiscal consolidation efforts. However, the difficulty in predicting the level and direction of change in energy prices underscores the need to keep the momentum of fiscal adjustment, put in place mechanisms for systematic implementation of countercyclical fiscal policy, and continue with the efforts for diversification.

Staff welcomes and supports the fiscal consolidation measures underway, and stresses that the adjustment needs to remain on track. The adjustment measures taken are a welcome step, but some revenue reforms have been delayed due to legislative and institutional constraints (e.g., the gaming tax, the Revenue Authority (RA), the Tax Policy Unit, and reintroduction of the property tax). Further cost savings from reduced transfers and subsidies await completion of the World Bank Public Expenditure Review (PER). The authorities should continue their efforts to address the obstacles to speedy implementation of the measures, and focus efforts on reducing reliance on non-core revenues.

Efforts should focus on delivering the targeted fiscal adjustment over the medium-term. Notwithstanding the improvement in FY2017/18 , the size of the imbalances calls for further adjustment, to create fiscal space for future commodity shocks, alleviate market concerns about the adequacy of fiscal and external adjustment, and put the public debt on a sustainable, downward trajectory. With the significant adjustment of 2.2 percent of GDP in FY2017, staff suggests measures (balancing between revenue-raising and current expenditure-containment) that yield about 4.4 percent of GDP paced over 4-5 years, which would contain central government debt around 30 percent of GDP and public debt below 55 percent. Many of these measures are already in train, but will require steadfast implementation over the medium-term.

On the revenue side, completing the energy taxation and tax administration reforms are a priority. Staff welcomes ongoing reforms to enhance the fiscal regime for oil and gas to reduce tax leakages, while providing attractive terms for investment. The RA would enhance revenue collection and cost-saving across agencies and address weaknesses in tax administration. Staff encourages speedy approval of RA legislation by Parliament, implementation of Tax Administration Diagnostic Assessment Tool recommendations, and acceleration of VAT refund payments owed to taxpayers. Higher taxes on tobacco or sugary drinks could be considered as a contingency measure, as well as a gradual increase in the VAT rate toward the regional average (15 percent).

On the expenditure side, containing current spending should remain a priority. Transfers to public utilities continue to represent a significant fiscal drain. Staff concurs with the authorities that raising utility tariffs should be guided by a rate determination exercise by the Regulated Industry Commission, and implemented with urgency. Identifying cost savings from the PER should suggest further cost savings in education, health, and social services. Redirecting savings from current spending to the most vulnerable segments of society and efficient, growth-enhancing public investment could deliver better returns (given higher fiscal multiplier), reducing the measures' negative social/growth impacts.

Staff welcomes the authorities' intention to establish a medium-term fiscal policy framework (MTFF). The framework should take into account potential uncertainties associated with commodity cycles and provide a systematic tool for countercyclical policy implementation to help insulate the economy from commodity price-driven volatility going forward. The HSF, which accumulates financial buffers from windfall savings, could in principle perform such a role, but the rules governing its inflows and outflows are neither linked to fiscal indicators nor based on longer-term fiscal sustainability assessments, limiting its potential as a countercyclical tool. Staff recommends adopting formal fiscal targets and a clearly-communicated MTFF to guide fiscal policy. The HSF should be fully integrated with the MTFF, and transfers to/from it should be linked to an appropriate fiscal target that provides the government with a commitment device to anchor its adjustments and shield against pressure to deviate from the adjustment path. Tailored TA could help determine an appropriate anchor(s) to support fiscal sustainability and implementation of countercyclical fiscal policy; the Fund stands ready to provide TA as needed.

In this context, the authorities should also consider adopting an asset-liability management framework. Public debt and the HSF need to be managed in an integrated framework, to limit situations where the authorities may need to borrow to save into the HSF (e.g., when running a fiscal deficit). The publication of a medium-term debt strategy should also facilitate borrowing at more favorable terms for the government, provide more clarity and predictability to the financial system, and reduce adverse implications of various borrowing strategies for financial institutions (e.g., increase in sovereign exposure), the government (e.g., higher borrowing cost), and the economy (e.g., higher inflation).

Other structural reforms to strengthen public sector management need urgent attention. Staff welcomes initiatives to reform the National Insurance System (NIS), with contribution income no longer sufficient to meet benefits payments since 2014. Staff welcomes proposals to further increase the contribution rate and gradually raise the effective retirement age from 60 to 65 starting in 2025 to keep the system sustainable and reduce contingent liabilities to the government. Urgent action is needed to increase efficiency and reduce labor rigidities in the public sector. Comprehensive public service reforms would increase the ability of the Public Services Commission Department and the Chief Personnel Officer to address the institutional constraints to enable efficient functioning of the government.

Restoring External Balance

The tightness in the FX market is believed to have eased compared to last year, but the market continues to be in a state of disequilibrium with strong excess demand. FX shortages remain despite the 7 percent nominal depreciation in 2016, the current account surplus in 2017, and increased FX inflows from energy companies, and notwithstanding the Central Bank of Trinidad and Tobago's bi-monthly intervention to maintain a stable exchange rate vis-à-vis the US $. Anecdotal evidence continues to suggest existence of an informal parallel market.

The impact of the shortages on the non-energy sector remains a concern. Some companies with large import needs reportedly left the market, with delays in settling bills and getting inputs for production, and some companies moved to import substitution. FX queuing also continues; while requests are eventually fulfilled, waiting time can range from 2-3 weeks to a month, depending on the amount, purpose, and the time of the request, and the frequency of business with the banks. Uncertainty about the availability of FX or expectations of a further depreciation are believed to incentivize FX hoarding that in turn contribute to tightness in the market.

T he FX market should be cleared on a sustained basis. Considering further potential volatility in energy prices, the authorities could take advantage of the current relatively stable period with low inflation and positive steps taken for fiscal consolidation to address the FX-shortages, by adjusting the price or supplying FX at the given exchange rate. While the US$100-million EximBank FX Facility introduced in May 2018 may help alleviate somewhat the FX shortage for eligible manufacturers to finance their inputs, it could add to market distortions if it is not carefully designed and implemented, and create incentives for misuse, as well as possibly introducing an exchange measure subject to the IMF's Article VIII. The Facility needs to be carefully designed to ensure transparency and consistency with international standards, and the authorities provide sufficient FX to meet demand for all current international transactions.

T he exchange rate could play a more active role as an automatic stabilizer and help manage the transition to a more balanced/flexible FX market. The currency remained broadly stable since the depreciation in 2016, while vulnerability to terms-of-trade shocks continues. Greater flexibility, implemented through a mechanism that allows some market force in determining the exchange rate, would facilitate adjustment to external shocks, help restore competitiveness, and safeguard foreign reserves. Implementing exchange rate adjustment gradually (within more flexible forms of a peg, such as widening bands) would permit two-way exchange-rate variation, and in so doing reduce incentives for FX-hoarding and one-way currency bets, while maintaining the exchange rate as nominal anchor.

In Staff's view, such a move requires careful design and implementation, if it is to be successful. Assessing balance-sheet exposures of the public and private sectors and exchange-rate passthrough to inflation would be important to make sure the arrangement does not result in adverse balance sheet problems. Accompanying the exchange rate move with supportive fiscal, monetary, financial, and structural policies, and safety nets, and a clearly-defined intervention (on when and how to intervene) and communication strategy (on what and when to announce) would help limit large movements and the rate being pushed quickly to band limits. Maintaining the current policy, which the authorities intend to, puts the burden of adjustment on fiscal, monetary, and structural policies, and requires ample reserve/fiscal buffers and adjustments with larger growth effects. Country experiences suggest that preserving a peg regime can provide a helpful anchor for undiversified economies, but only with large financial buffers and credible fiscal adjustments under persistent shocks.

Addressing Monetary Policy Challenges

Regardless of the FX policy, the CBTT should continue to set its monetary policy stance consistent with fiscal, monetary, and exchange rate policies. In setting the policy rate, the CBTT has been striking a balance between supporting the recovery, while being cognizant of the possible effect of a further narrowing of the TT-US short-term interest rate differential on capital outflows and pressure on the currency. As the differential fell below parity during 2018 with rising US interest rates and relatively stable domestic rates, staff supports the decision to increase the repo rate to 5 percent on June 29, taking into consideration the signs of pickup in economic activity, low inflation, and the likely impact of a further rise in the US interest rate differential on external balance. Further rises in the US interest rate differential could complicate monetary policy, making it difficult to maintain the rate to support economic recovery. Monetary policy will bear the burden of adjustment in the absence of exchange rate flexibility and very ambitious fiscal consolidation. In staff's view, allowing a gradual exchange-rate adjustment within the constraints of a band could provide some scope for more flexible monetary policy.

Safeguarding Financial Sector Stability

The financial system has remained remarkably stable notwithstanding the deep recession in the past two years, but there are pockets of vulnerabilities. Banks continue to be well-capitalized and profitable and credit quality remains relatively high, with NPL ratios one of the lowest in the region. The recession has not been fully reflected in unemployment until recently, but early-2018 data indicate weaknesses in asset quality (for real estate, construction, and credit cards), with some increase in the overall level of past due loans for 30-89 days. With the robust growth in private-sector credit in 2018, staff welcomes the authorities' vigilance in monitoring credit quality developments, given high indebtedness of the household sector, sovereign exposures, and relatively low domestic interest rates. An increasingly interconnected and complex financial system, cross-border presence of insurance companies, and gaps in the oversight framework for credit unions and mutual funds, call for careful monitoring of systemic risks. Staff looks forward to the upcoming FSAP to assess the overall financial system stability.

Efforts must focus on risk-based, consolidated, cross-border supervision . In this context, systematic monitoring of bank profitability, asset quality, loan-loss-provisioning, and classification are key. Banks' FX and sovereign exposures are well managed, but indirect exposures must be ascertained with systematic monitoring of exposures and an appropriate

prudential oversight, in particular in a stable exchange rate environment. Implementation of Basel II is on track for January 2019 and progress has been made on the recent TA recommendations on mutual funds and credit unions. The Insurance Bill was passed but must be proclaimed to become law, which will then be a significant milestone towards strengthening supervision of the insurance sector, promoting good governance and risk management practices, and prudential regulation and oversight of financial groups.

The AML/CFT framework must be strengthened to avoid remaining on the FATF list of jurisdictions with strategic deficiencies, and limit potential fallout for financial institutions. While FATF International Cooperation Review Group (ICRG) noted the significant progress made in addressing the existing deficiencies, further improvements are needed, with the removal from the ICRG list pending the passage of legislation and other measures to effect reform in the deficient areas. The legislation is with the Joint Select Committee to be compliant with aspects of the Global Forum, but the jurisdiction must still resolve some issues of discriminatory tax treatment. Notwithstanding, no CBR losses have been observed since the 2016 IMF survey, but banks devote significant resources to due diligence, relationship maintenance, and increased fees in drafts. Some banks de-marketed some customers and business lines seen as high risk (casinos, gaming, money businesses, and drafts). No significant impact has yet been observed from tax black-listing or Global Forum decisions, but banks wait for assurances from the government on legislations put forward to Parliament.

Structural Reforms to Support Sustainable Growth

Reforms to improve the business environment are crucial to support fiscal adjustment and boost economic growth. With the economy heavily-dependent on the energy sector, obstacles to non-energy growth must be addressed and diversification efforts intensified. Efforts to support tourism should continue, given its linkages to agriculture, services, and lite-manufacturing, and obstacles to its growth (e.g., air/sea connectivity, cost of doing business, and access to finance) should be addressed. Institutional reforms should focus on improving paying taxes and enforcing contracts, and legal frameworks should facilitate legislative-passage of ongoing reforms. Violent crime, with homicide rates one of the highest in the Caribbean, presents a drag on the economy, with direct crime-related costs from public, private, and social spending estimated at 3.5 percent of GDP—around the average for the Latin American and Caribbean region . Staff supports government efforts for crime reduction and suggests a balanced approach with prevention and crime-control programs.

Important progress has been made to address data quality and coverage, but further efforts are needed, particularly in national accounts and balance of payments. Data quality and timeliness continue to limit ability to assess vulnerabilities and policymaking. Methodological improvements following CARTAC technical assistance resulted in substantial changes in the current account historical data. While this enhanced the robustness of the data, frequent changes in data make the task of external assessment difficult. The move to the independent National Statistical Institute is ongoing but sustained efforts are needed to build statistical capacity and prioritize commencement of its operations. The household budget survey and the survey of living conditions need full funding to improve data timeliness and quality. The Economic Management Division of the Ministry of Finance needs to attract and retain staff to assist in fiscal planning. Inter-agency collaboration is key to the production of timely and accurate data.

The mission thanks the authorities and technical staff for the warm welcome, constructive discussions, and positive spirit of cooperation.

Table 1. Trinidad and Tobago: Selected Economic Indicators*

GDP per capita (U.S. dollars, 2017)	$16,819	Adult literacy rate (2015)	99
Population (millions, 2016)	1.35	Gini index (2010)	40.3
Life expectancy at birth (years, 2015)	70.6	Unemployment rate (Q2 2017)	5.3
Under 5 mortality rate (per thousand, 2016)	18.5	Human Development Index (2015)	65

Selected Economic and Financial Indicators

						Projections				
	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
	(Annual percentage changes, unless otherwise indicated)									
National income and prices										
Real GDP	-1.2	1.7	-6.1	-2.6	1.0	0.9	1.6	2.1	1.2	2.2
Energy	-2.0	-1.4	-10.0	-0.3	6.0	2.4	2.2	2.9	-0.1	1.6
Non-energy 1/	-0.7	3.6	-3.8	-3.8	-1.8	0.0	1.2	1.6	2.1	2.5
GDP deflator	1.8	-12.6	4.0	5.0	1.2	2.9	2.9	3.6	3.9	3.8
Consumer prices (headline)										
End-of-period	8.4	1.6	3.1	1.3	2.3	3.1	3.0	3.7	3.7	3.7
Period average	5.7	4.7	3.1	1.9	2.3	3.1	3.0	3.7	3.7	3.7
Consumer prices (core)										
Period average	2.0	1.8	2.2	2.2	2.1	2.1	2.1	2.1	2.1	2.1
Unemployment rate 2/	3.3	3.4	4.0	4.9	...	...	...	...	...	...
Real effective exchange rate (2010=100)	117.1	129.7	128.3	125.3	...	...	...	...	...	...
	(In percent of fiscal year GDP)									
Nonfinancial public sector (NFPS) 3/										
Central government overall balance	-4.5	-8.0	-11.7	-11.0	-6.0	-4.6	-3.8	-3.3	-3.2	-3.0

Of which: non-energy balance 4/	-21.8	-21.4	-18.0	-17.2	-15.1	-15.2	-14.7	-14.3	-13.9	-13.5
Budgetary revenue	31.1	29.6	22.7	21.3	25.7	27.4	27.9	28.0	27.8	27.7
Budgetary expenditure	35.6	37.6	34.5	32.2	31.7	32.0	31.7	31.3	31.1	30.7
Of which : interest expenditure	1.8	2.2	2.0	2.9	2.9	2.8	2.8	2.7	2.7	2.6
Of which : capital expenditure	4.9	4.8	2.9	2.2	2.4	3.0	3.0	3.0	3.0	3.0
Central government debt 5/	23.9	28.0	37.0	41.8	42.7	42.9	43.1	42.9	43.3	43.3
Gross NFPS debt 5/	40.4	48.0	57.6	60.9	62.5	63.5	64.1	64.1	64.5	64.3
Heritage and Stabilization Fund assets	20.3	22.8	24.9	25.4	26.0	26.3	26.4	26.1	25.9	25.6
(In percent of GDP, unless otherwise indicated)										
External sector										
Current account balance	14.7	7.6	-2.9	10.2	10.6	7.1	6.0	5.7	5.3	5.4
Exports of goods	55.1	47.1	36.3	43.6	52.6	50.8	47.8	45.8	43.4	41.7
Imports of goods	29.2	31.0	30.3	26.8	33.1	35.5	34.0	32.6	31.0	29.6
External public sector debt	8.6	10.3	15.4	16.4	16.0	16.9	17.4	17.5	17.7	17.7
Gross official reserves (in US$ million)	11,493	9,927	9,466	8,370	7,542	6,937	6,398	5,954	5,716	5,574
In months of goods and NFS imports	13.2	12.3	12.6	9.4	7.8	7.2	6.5	6.0	5.8	5.6
(Annual percentage changes)										
Money and credit										
Net foreign assets	7.6	-7.7	2.3	-9.3	-7.2	-5.6	-5.2	-4.4	-2.3	-1.2
Net domestic assets	4.0	46.2	6.5	26.8	20.6	8.7	10.1	9.8	10.4	11.0

Of which: credit to the private sector	6.7	6.6	3.6	4.9	6.0	5.9	6.7	6.9	6.4	6.5
Broad money (M3)	7.2	1.1	2.8	-0.4	1.3	-0.4	0.9	1.7	3.6	4.9
M3 velocity	1.7	1.5	1.4	1.5	1.5	1.5	1.6	1.7	1.7	1.7
Memorandum items:										
Nominal GDP (in billions of TT$)	174.1	154.7	151.0	154.4	157.8	163.9	171.3	181.2	190.6	202.1
Non-energy sector in percent of GDP	65.1	77.8	79.2	74.9	68.9	69.2	70.3	71.0	71.8	72.0
Energy sector in percent of GDP	34.9	22.2	20.8	25.1	31.1	30.8	29.7	29.0	28.2	28.0
Public expenditure (in percent of non-energy GDP)	55.0	50.5	43.7	42.4	45.0	46.2	45.3	44.3	43.4	42.6
Exchange rate (TT$/US$, end of period)	6.38	6.43	6.78	6.78	...	...	...	...	...	...
Crude oil price (US$/barrel)	96.2	50.8	42.8	52.8	70.2	69.0	65.0	62.1	60.1	58.8
Henry Hub natural gas price (US$ per MMBtu)	4.4	2.6	2.5	3.0	2.9	2.8	2.7	2.7	2.7	2.7

Sources: Trinidad and Tobago authorities; UN Human Development Report; WEO; and IMF staff estimates and projections.

1/ Includes VAT and Financial Intermediation Services Indirectly Measured (FISIM).

2/ 2017 reflects Staff projection.

3/ Data refer to FY year; for example, 2017 covers FY17 (October 2016-September 2017).

4/ Defined as non-energy revenue minus expenditure of the central government.

5/ Excluding debt issued for sterilization.

***** Among the announced measures, staff's baseline includes yields only from those related to the property, corporate, and royalty tax, but not those from PER, gaming tax, the RA or procurement reform.

[1] (file:///C:/Users/GHawkins/OTmp/Trinidad%20and%20Tobago_2018%20CS%20(002).docx) Historical current-account data was revised significantly with recent CARTAC technical assistance, which resulted in an upward revision of trade data since 2011, and a sizeable reduction in 2016 current account deficit.

MEDIA RELATIONS

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