***SOVEREIGN*: Trinidad and Tobago**

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Summary

The economic condition in Trinidad and Tobago remains fluid with the risk of growth tilted toward the downside. The general outlook is that inflation will rise over the medium-term, but should remain relatively subdued in part due to low fiscal spending and slow upward adjustments in household income. Depreciatory pressures in the foreign currency market are likely to persist throughout 2018 if the authority maintains its current stance. It is our opinion however that at some point in the near future the Central Bank of Trinidad and Tobago (CBTT) will commence the cycle of rate increase, not necessarily on the accord of domestic economic factors, but rather to match the rate rise in the US to mitigate the risk of capital flight.

Introduction

The ongoing challenges in the Petroleum industry are slowly abating however it will take some time before the economy fully rebounds. Having contracted by 2% in CY 2016, we were of the opinion that the economy would have rebounded in the second half of 2017 (H2:17) due to incremental increases in hydrocarbon prices and output. While complete data is not yet available for output in Q3:17, information garnered from other sources suggests that output declined during the period. Based on observation the economy is expected to contract in calendar year 2017. The outlook for the short- to medium-term looks more promising, as green shoots from new oil installations should result in higher production flows for crude oil and gas. Additionally, we are forecasting increases in hydrocarbon prices through the medium term. The combination of both these favourable outturns should help to drive real output in the future.

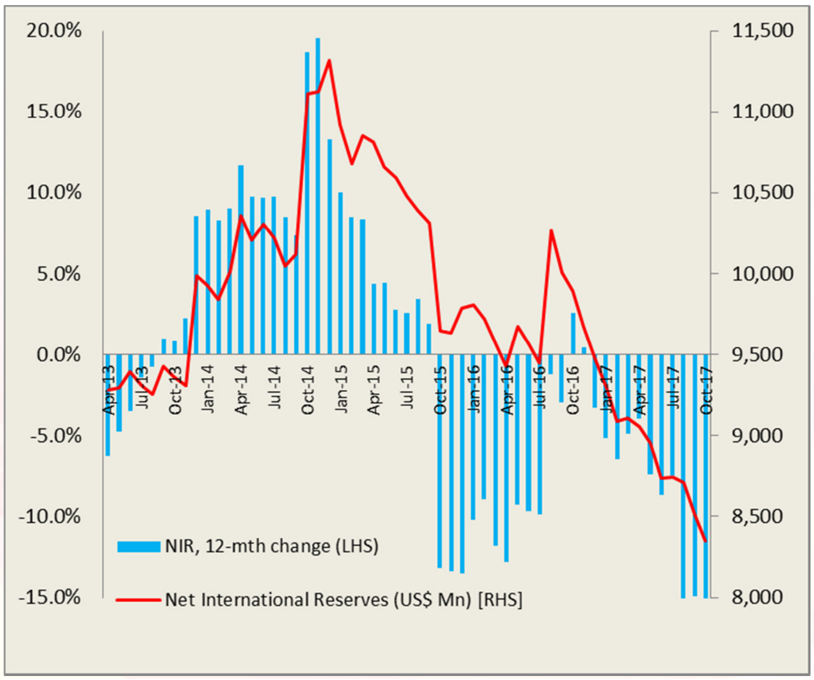
Fiscal policy

As we have outlined in previous publications, the Government of Trinidad and Tobago (GOTT) has taken decisive steps to cull the budget deficit. While the measures undertaken may not necessarily be deemed deep enough, they are nonetheless geared towards meeting the fiscal objective over the medium-term without being too disruptive to the domestic economy. It is early days yet so there is not a clear picture in regards to revenue flows from the tax measures announced in September. Based on observations in other jurisdictions beset with related economic circumstances and that have instituted a similar set of tax measures, revenue flows from sin taxes are relatively certain however inflows from value-added tax (VAT) are less so, as performance is highly correlated to the pace of economic expansion, the level of tax compliance and administrative efficiency. The sovereign is lagging in all these areas.

It remains to be seen if the synergy between the Inland Revenue department and Customs will help to improve tax compliance and efficiency. Undoubtedly improvements are likely to result from the peering of both of these institutions, but this will take time and as such may not be reflected in the expected revenue flows for FY 2018.

Exchange Rate

Figure 1: Reserves and change in reserves



Source: Central Bank of Trinidad and Tobago and JJMMBIR

The domestic currency remained stable throughout 2017 despite continued pressure in the foreign exchange market. Undoubtedly there is political risk associated with the sharp depreciation of the TT-dollar as the general populace view the currency as sacrosanct. The authority has acquiesced to political pressure despite the sovereign running twin deficits - fiscal and current account. Both these deficits have their genesis in falling terms of trade arising from a sharp decline in hydrocarbon prices. The forecast over the short-to medium-term is pointing towards continued erosion in the current account and a lower but still elevated fiscal deficit. The impact from both will be felt in the currency market. If the authority is steadfast in holding the domestic currency stable, it will come at the detriment of a continued decline in reserves, and containment in the growth outlook for the nonpetroleum sector due in part to uncompetitive prices.

The macroeconomic fundamentals are pointing towards depreciation of the domestic currency. However, given the entrenched mind-set of the authority, there are genuine fears that the depreciation of the TT-dollar could have negative political implications. Notwithstanding, we are of the view that the TT-dollar will depreciate over the next 12-months or so. In the event that the authority decides against this happening we can reasonably expect reserves falling and slow recovery in the nonpetroleum sector, as the currency is overvalued.

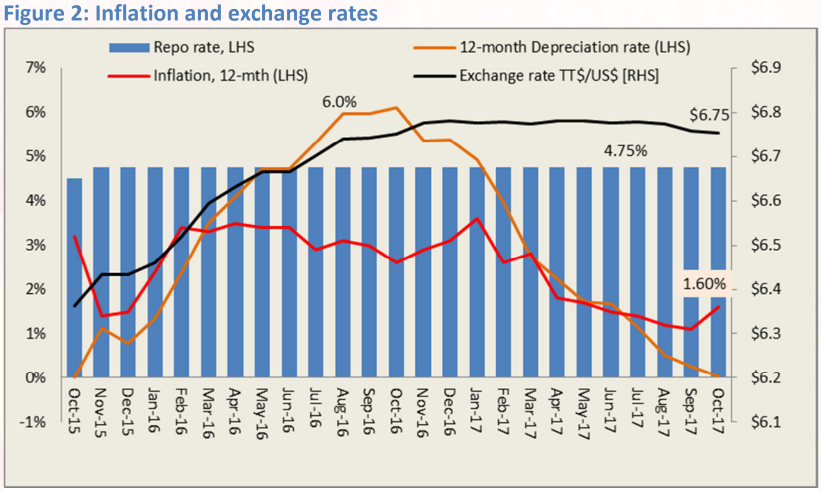
Inflation

The inflation rate in Trinidad and Tobago continues to benefit from a combination of sluggish economic activities and favourable international and domestic prices. The inflation rate in 2016 averaged 3% compared to 2% during the first 9 months in 2017. For the month of September the headline inflation rate was 1.1%, but is expected to rise in Q4:17 consequent on the GOTT tax package. The general outlook is that inflation will rise over the medium-term, but should remain relatively subdued in part due to low fiscal spending and slow upward adjustments in household income.

Interest rate

The Central Bank's (CBTT) policy rate has remained fixed at 4.75% since November 2015 despite mounting pressures in the currency market. The policy action of the Bank is supported given the overall economic environment, in particular sluggish output in the nonpetroleum sector. The Bank has had to gauge activities in the currency market and the real sector in an environment where the United States Federal Reserves (Fed) is increasing rates. In late December the Fed increased rates for the third time in 2017 for an overall increase of 75 basis points. We have always maintained the view that the CBTT at some point will have to commence the cycle of rate increases, not necessarily on the accord of domestic economic activities, but rather to match the rate rise and the maintain the spread differential in the US to mitigate the risk of capital fight.

Figure 2: Inflation and exchange rates



Source: CBTT and JMMBIR

IMF Article IV Consolation

Arising from the Article IV consultation with the authority in Trinidad and Tobago the Directors of the International Monetary Fund (IMF) noted that "the government has taken steps to adjust fiscal imbalances, through efforts to reform the energy tax regime, reduce fuel subsidies, and boost non-energy revenues. It was noted that the sovereign has engaged the World Bank to conduct a Public Expenditure Review, which will aim to identify cost-savings in health, education, and social services." The Fund advised that in regards to monetary policy the Central Bank stopped its tightening cycle at end-2015, given the severity of the economic downturn, and has subsequently held interest rates constant. The external balance model of the IMF suggests that the exchange rate is overvalued. It was noted that the domestic banking system remains resilient and profitable**.**

In closing the Directors of the IMF underscore the importance of the implementation of key structural reforms to boost growth. They stated that in order to achieve this outcome Trinidad and Tobago needs to implement labour market reforms and remove structural rigidities in the public sector, improve conditions to boost output in the non-petroleum sector, and improve efficiency in state run entities. The Directors are pleased with the steps taken by the authority towards the creation of the National Statistical Institute to address remaining data shortcomings to strengthen policy making and surveillance.

Conclusion

The economic conditions in Trinidad and Tobago remain fluid with the risk of growth tilted toward the downside. The outlook is for a moderate rise in inflation, which should however remain subdued as a result of low economic activities in both the public and private sectors. Consequent on increases in Fed rates and further expected rate adjustments in 2018, we are projecting that the CBTT will increase the repo rate, albeit with a lag. While the CBTT remains steadfast in preserving the repo rate in order to facilitate improved economic activities in the non-petroleum sector, it will have to carefully gauge this against the risk of outflows of funds from portfolios in search of higher returns. The interest rate differential between TT- and US-dollar assets has narrowed substantially and is moving into negative territory.

The growth outlook for Trinidad and Tobago is showing signs of moderate improvement (1% - 2%) over the short- to medium-term. This is heavily predicated on increases in hydrocarbon prices and higher output in the petroleum sector. A large share of the growth however is due to economic recovery following five years of low or negative growth rates. The growth potential for the non-petroleum sector is fairly balanced at this time. On the one hand increased domestic economic activities in the petroleum sector will have positive spillover effects on the wider economy while on other hand slow and low growth across the Caribbean will limit export growth.

Depreciatory pressures in the foreign currency market are likely to persist throughout 2018 if the authority maintains its current stance. We however believe the CBTT will acquiesce to market forces at some point in near future and allow orderly depreciation of the domestic currency to help ease the pressure in the foreign exchange market as well as to help improve the competitiveness of nonpetroleum exports.

Source:

Central Bank of Trinidad and Tobago
IMF

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