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Trinidad and Tobago: Selected Issues

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TRINIDAD AND TOBAGO

Selected Issues

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Approved by the Western Hemisphere Department

October 4, 2004

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I. The Energy Sector[1]

A. Background

1. **Trinidad and Tobago has had a long history of oil exploration and production**. As early as 1855, the first geological survey was undertaken so as to map possible areas for oil exploration. Early attempts to develop the oil industry were all carried out by private entrepreneurs, mainly from the United States and the United Kingdom. In 1911–12, Trinidad Oilfields Limited made a successful oil strike, and the first shipment of oil took place in 1910. Oil production received a strong boost in 1914, as a result of World War I, with oil production surpassing the 1 million barrel mark for the first time. In 1917, the first refinery was established.

2. **The energy sector has since taken on a central role in the economy of Trinidad and Tobago**. In 2003, it accounted for nearly 40 percent of GDP, 83 percent of exports of goods, 41 percent of central government revenues, but contributed only about 3 percent to employment (Table 1). Since the late 1970s, the energy production structure in Trinidad and Tobago has shifted from primarily oil-based to natural and gas-based petrochemical production. Natural gas production increased from 346 million cubic feet per day (mmcf/d) in 1975 to 2,594 mmcf/d in 2003. The expansion of the gas sector received a major boost in 1999, when the Atlantic Liquefied Natural Gas Company (ALNG) began operations. Trinidad and Tobago has developed its petrochemical and liquid natural gas (LNG) mainly for exports.

B. Structure of the Sector

3. **Proven oil and gas reserves were estimated to be around 4,500 million barrels of oil equivalent**. Of this, gas accounts for more than 80 percent. If, however, probable and possible reserves are also included,[2] oil and gas reserves amount to almost 9,000 million barrels (Figure 1). In 2003, oil production in Trinidad and Tobago was approximately

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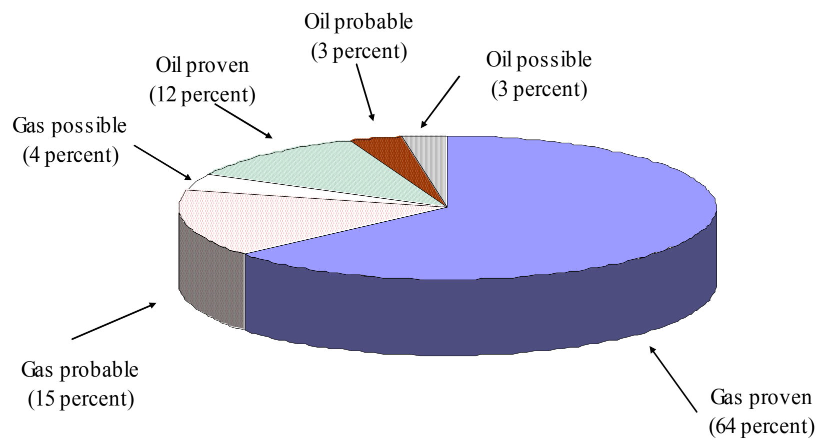
[1] Prepared by Phebby Kufa and Saqib Rizavi (WHD). The authors benefited from extensive comments by Ms. Sandra Racha (CBTT) and Ms. Carol Bikram (Inland Revenue Board).

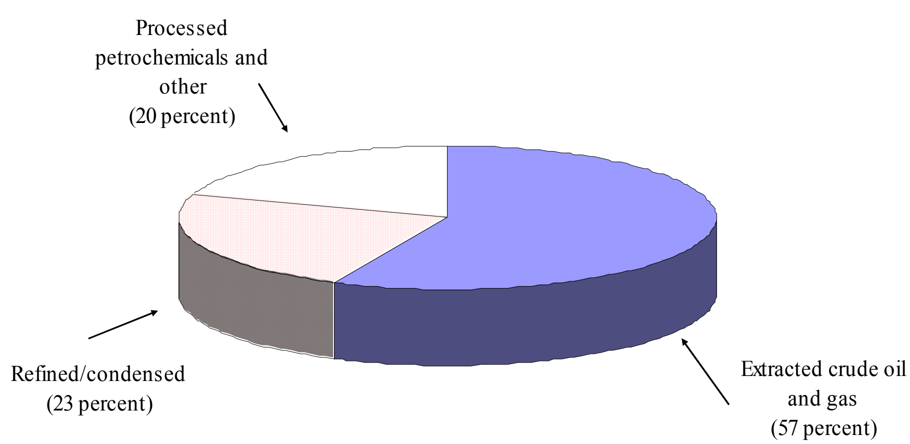
[2] According to the Ministry of Energy and Energy Industries (MEEI), this estimate is based on the following probabilities: 90 percent for proven oil reserves; 50 percent for probable oil reserves; 10 percent for possible oil reserves; 100 percent for proven gas reserves; 60 percent for probable gas reserves; and 20 percent for possible gas reserves.

Figure 1. Trinidad and Tobago: Structure of the Energy Sector, 2003

Risked Energy Reserves
(In percent of the total)



Composition of Energy Sector
(In percent of energy sector value added)



Source: Ministry of Energy and Energy Industries.

134,000 barrels of oil per day (bopd), and 500,000 boe of gas per day. Based on reserves to production ratios, the country's energy resources could last for almost 40 years.[3]

4. **Trinidad and Tobago's energy sector is dominated by large international companies or their affiliates**.[4] The government's involvement mainly stems from the existence of large state-owned companies, such as the Petroleum Company of Trinidad and Tobago (PETROTRIN), the Natural Gas Company (NGC), and the National Petroleum Marketing Company (NPMC), as well as the government's minority shareholding in private companies (Table 2). The energy companies are involved in extracting, refining or condensation, processing and distribution (Figure 2).

- British Petroleum and PETROTRIN are the main crude oil producing companies accounting for 45 and 50 percent of total, respectively. British Petroleum is the only exporter of crude oil. PETROTRIN has a refining capacity of 175,000 bopd and is the sole refinery in Trinidad and Tobago. It complements its crude oil production with purchases from the smaller producers, and imports more than half of its requirement from Venezuela. NPMC is the main company distributing refined petroleum in the domestic market.

- British Petroleum is also the major natural gas producer, accounting for 70 percent of total gas output. British Gas and four smaller companies produce, respectively, about 23 percent and 7 percent of the total natural gas output.

- Approximately 60 percent of all gas produced in Trinidad is exported directly as LNG (the country is the fifth largest exporter of LNG in the world). There are currently three LNG plants in operation—ALNG Train I, ALNG Train II, and ALNG Train III. With the exception of Train I, in which the government holds 10 percent of the shares, these trains are owned mainly by multinational companies such as BPTT, BGTT, and Repsol.

- The remaining 40 percent of the natural gas output is used by NGC, established in 1975 to spearhead the country's natural gas-based industrialization efforts. NGC compresses, transports, and distributes natural gas to companies on the Point Lisas Industrial Estate for use in the larger petrochemical and other smaller plants. The petrochemical industry mainly produces methanol, ammonia, and urea.

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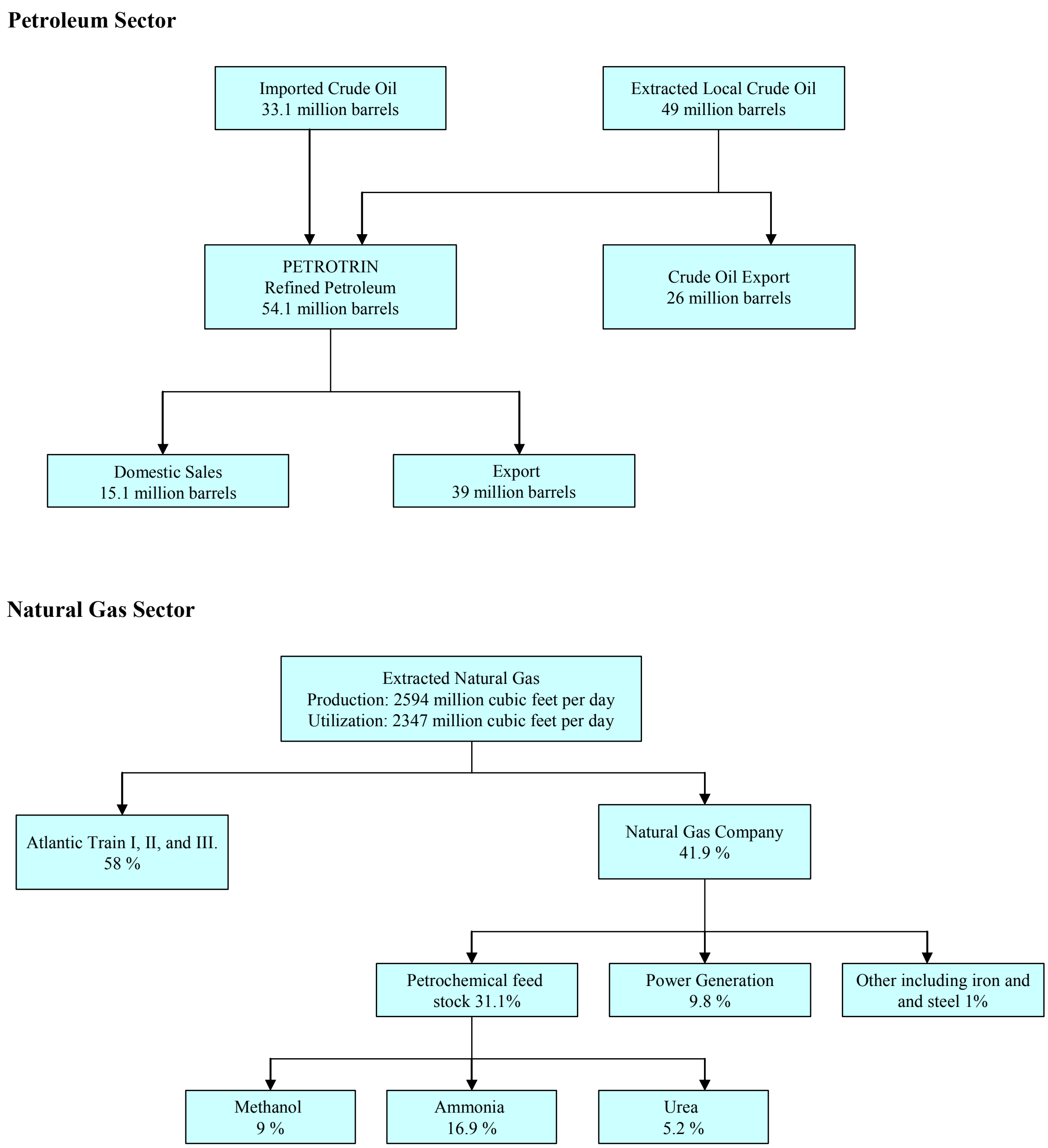
[3] Given that the reserves-to-production ratios are based on existing reserves and current extraction rates, and do not take into account the possibility of any new discoveries, these figures should only be treated as indicative.

[4] For example, British Petroleum, British Gas, BHP Billiton, Chevron Texaco, Total, Talisman, and Repsol.

Figure 2. Trinidad and Tobago: Sources and Uses of Energy Resources, 2003



Source: Ministry of Energy.

C. Growth Prospects

5. **Significant further expansion is expected in the energy sector over the next few years**. This is predicated on expansion underway in the LNG sector, potential contribution of the newly discovered oil and gas fields, and the expected growth in the downstream petrochemical industry.

- In addition to the already established Trains—I, II, and III—a fourth plant (Train IV) is currently under construction, and is expected to be completed by end-2005/early 2006. This plant will have an annual production capacity of 5.2 million metric tons of LNG (45 million boe).
- In 2001, BHP Billiton announced the discovery of a major oil field located in the northeastern coast of Trinidad. This has a potential to produce of up to one billion barrel of oil and about 2.5 trillion cubic feet of natural gas (450 million boe). Production from this discovery is scheduled to begin in December 2004.
- In mid-2004, production in the petrochemical sector was further enhanced and expanded when an ammonia plant and a mega-methanol plant began operations. An additional methanol plant is expected to come on stream in late 2004/early 2005.

D. Economic and Fiscal Contribution

6. **While direct employment generated by the energy sector remains relatively small, its contribution to value added and investment have increased rapidly in recent years**. The energy sector accounts for less than 4 percent of direct employment as the related projects are highly capital-intensive. However, its contribution to real GDP growth reached 80 percent in 2003 as LNG trains II and III came on stream. The share of the energy sector in total GDP rose to above 40 percent in 2003

7. **Trinidad and Tobago has production-sharing agreements in both the oil and natural gas sectors**. Most new contracts for oil and gas development are production-sharing contracts, following global trends in this area. Under these contracts, the government accepts cash payments for its share of production rather than actually taking possession of the natural resource. As set out in the contracts, the share may vary from year to year, depending on the cost of production, output prices, and other factors. No royalties apply to these production-sharing contracts.

8. **The government budget is heavily dependent on revenues from the energy sector**. In FY 2002/03, energy-based revenues constituted slightly more than 40 percent of total budgetary revenue (Table 3). The relative tax burden of the energy sector (i.e., tax share relative to the sector's share in total value-added), increased from 64 percent in 1998 to 76 percent in 2003. More than 50 percent of energy-based revenue is in the form of receipts of the petroleum profit tax and supplemental petroleum tax. Notwithstanding the expansion in the gas processing and petrochemical subsectors, contribution to revenue from these remains low as a number of entities operate under tax holidays and/or are allowed to offset

their tax liabilities against capital costs. Accordingly, their tax contribution is expected to increase in the future with the expiration of tax holidays and the recovery of capital cost.[5]

9. **The tax regimes that apply to oil and gas are different, though both are based on production and income taxes**. For oil, production-based receipts consist of: (i) royalties of 10 percent on onshore oil sales and 12.5 percent of offshore sales; (ii) a petroleum production levy, at a maximum rate of 3 percent; and (iii) a small petroleum impost, which is used to cover administrative expenses of the Ministry of Energy. Income-based taxes consist of: (i) a petroleum profit tax, levied at a 50 percent rate on profits from oil production; (ii) an unemployment tax levied at a 5 percent rate on profits from oil production (this tax is not deductible against the profits tax); and (iii) a supplemental petroleum tax levied on crude oil sales (less certain allowances for exploration and investment), at a sliding rate that varies with the price of oil, when the development license was granted, and when production began. For gas production, companies are liable to pay royalties at a rate negotiated with the government. These companies (including petrochemical companies) also pay the corporate income tax at the standard rate of 35 percent on profits, and the petroleum impost.

10. **The royalty rate for gas production in Trinidad and Tobago is extremely low by international standards**. Most of the gas production (about 70 percent) is subject to a specific royalty of only TT$0.015 per mcf if used domestically, and TT$0.02 per mcf if exported. In ad valorem terms, the royalty is less than 0.3 percent of the value of the natural gas. For some time, the government has been considering ways to increase revenue from the natural gas resources. Options to adjust the gas royalty under the existing exploration and production contract are somewhat limited, since royalty rates are specified in the license agreements. Altering these long standing agreements would be viewed by the concerned companies as reneging on contractual commitments. Moreover, a significant volume of the natural gas produced is sold to the state-owned NGC under long term contracts that contain pass-through arrangements. As such, any increase in the royalty rate would be passed on to NGC, and thus could indirectly result in lower government revenue. These issues have constrained government's ability to change policy not only with respect to natural gas royalties, but also with respect to other levies on the production of gas.

E. Contribution to the Balance of Payments

11. **In recent years, the performance of the energy sector has been the main determinant of the external current account balance (Table 4)**. The current account surplus rose sharply by about 12 percentage points of GDP in 2003, to 13 percent of GDP, reflecting high oil and gas prices and increased volume of gas exports. The share of energy sector exports in total merchandise exports rose from an average of 78 percent in 2000–02 to

[5] Trinidad and Tobago's fiscal regime also offers significant tax incentives to energy producers. The main incentives are an income tax holiday spanning a period of 5–10 years on new investments; exemption from import duties and value-added tax on imports; and exemption from withholding taxes.

83 percent in 2003. This was largely a result of the expansion in the extracting and refining industries, as ALNG Trains II and III began production. Investment income payments abroad by the energy sector, which averaged 5 percent of GDP in 2001–02, declined to 3 percent of GDP in 2003, reflecting increased re-investment by the energy companies.

12. **The United States is the largest market for Trinidad and Tobago's crude oil and natural gas exports**. The share of exports to the United States in 2003 was 100 percent and 86 percent, respectively, for crude oil and LNG. Other export markets for energy-related products include Spain, Japan, and some countries in the Caribbean region.

13. **The energy sector has a major impact in the capital account of the balance of payments through the related FDI**. Cumulative foreign direct investment in the energy sector over the last five years has been about US$4 billion, nearly 50 percent of the country's average GDP over the same period. Indeed, the energy sector of Trinidad and Tobago is financed mainly through foreign direct investments. This reflects the ownership structure of the sector, and the large amounts of capital required relative to the size of the economy. The domestic financial system's involvement in the energy sector is through loans given mainly to locally owned companies that provide services to the foreign firms. Less than 10 percent of domestic bank's outstanding loans are directed to the energy sector.

Table 1. Trinidad and Tobago: Economic Contribution of the Energy Sector, 1999–2003
(In percent unless otherwise specified)

	1999	2000	2001	2002	2003
Share of employment	3.1	3.2	3.0	3.3	3.3
Share of GDP					
Energy sector	29.2	42.5	37.9	33.4	41.5
Extracted 1/	5.4	7.0	5.1	6.6	7.7
Refined 2/	16.0	26.5	23.6	19.5	25.2
Processed 3/	7.8	9.1	9.2	7.3	8.6
Share of government revenues					
Energy sector	16.1	30.2	36.6	31.1	41.1
Oil and gas exploration and production	4.7	20.1	19.3	16.4	25.0
Other taxes	11.4	10.1	17.3	14.8	16.1
Share of merchandise export receipts					
Energy sector	71.0	81.2	78.2	75.9	83.3
Extracted 1/	13.0	13.4	10.5	14.9	15.5
Refined 2/	38.9	50.5	48.7	44.5	50.5
Processed 3/	19.0	17.3	18.9	16.5	17.2
Memorandum items:					
Crude oil and condensate production, in million of barrels	45.7	43.7	41.5	47.8	49.1
Natural gas liquids production, in million of barrels of oil equivalent	5.7	7.0	7.5	8.6	10.1

Sources: Trinidad and Tobago authorities; and Fund staff estimates.

1/ The value added refers to crude oil and gas extracted, and exports refers only to crude oil.
2/ This includes refined petroleum, liquefied natural gas and natural gas liquids.
3/ This refers to all other energy related e.g., petrochemicals.

Table 2. Trinidad and Tobago: Energy Extraction Companies, June 2004
(In percent)

	Ownership	Share of production
Crude petroleum		
BP	Foreign	44.7
PETROTRIN-TRINMAR SBU	Government	29.7
PETROTRIN E&P SBU	Government	20.4
EOG	Foreign	3.5
British gas	Foreign	0.7
TRINTOMAR	Government	0.5
PRIMERA	Domestic private	0.4
MORAVEN	Domestic private	n.a.
Total		100
Natural gas		
BP	Foreign	65.2
British gas	Foreign	22.6
EOG	Foreign	7.7
PETROTRIN	Government	3.2
PETROTRIN-TRINMAR SBU	Government	1.3
VENTURE	Government	n.a.
Total		100

Source: Ministry of Energy.

Table 3. Trinidad and Tobago: Energy-Based Government Revenues

	1998/99	1999/00	2000/01	2001/02	2002/03
	(In percent of total revenues)				
Energy sector	16.1	30.2	36.6	31.1	41.1
Corporation tax	4.7	20.1	25.7	19.1	29.0
Oil and gas exploration and production	4.7	20.1	19.3	16.4	25.0
Gas processing	...	...	3.8	1.9	2.8
Petrochemicals	...	...	2.6	0.7	1.2
Royalties	5.1	4.7	5.1	5.3	5.8
Unemployment levy	0.5	1.2	1.3	1.1	1.7
Withholding tax	0.2	0.2	0.9	0.8	0.9
Excise duty	5.7	4.0	3.4	4.6	3.2
Green fund levy	0.0	0.0	0.3	0.4	0.5
	(In percent of GDP)				
Energy sector	3.9	7.4	9.9	6.4	11.3
Corporation tax	1.1	5.0	7.0	3.9	7.9
Oil and gas exploration and production	1.1	5.0	5.2	3.4	6.8
Gas processing	...	...	1.0	0.4	0.8
Petrochemicals	...	...	0.7	0.2	0.3
Royalties	1.2	1.2	1.4	1.1	1.6
Unemployment levy	0.1	0.3	0.3	0.2	0.5
Withholding tax	0.1	0.0	0.2	0.2	0.2
Excise duty	1.4	1.0	0.9	0.9	0.9
Green fund levy	0.0	0.0	0.1	0.1	0.1

Source: Trinidad and Tobago authorities.

Table 4. Trinidad and Tobago: Energy-Related External Flows

	1999	2000	2001	2002	Prel. 2003	Proj. 2004
	(In millions of U.S. dollars)					
Current account	31	544	445	76	1,351	919
Energy related	847	1,615	1,285	880	1,953	2,407
Non-energy related	-816	-1,071	-840	-804	-602	-1,487
Financial account	149	-106	25	-28	-1,017	-436
Energy related	468	614	816	738	1,182	1,774
Non-energy related	-318	-720	-791	-766	-2,199	-2,210
	(In percent of GDP)					
Current account	0.4	6.6	5.0	0.9	12.8	7.3
Energy related	12.4	19.7	14.5	9.9	18.5	19.2
Non-energy related	-11.9	-13.1	-9.5	-9.0	-5.7	-11.9
Financial account	2.2	-1.3	0.3	-0.3	-9.6	-3.5
Energy related	6.8	7.5	9.2	8.3	11.2	14.1
Non-energy related	-4.7	-8.8	-8.9	-8.6	-20.9	-17.6
	(In millions of U.S. dollars, unless otherwise specified)					
Memorandum items:						
Exports	2,816	4,290	4,304	3,920	5,256	6,523
Energy sector	1,999	3,483	3,365	2,976	4,376	5,352
Extracted 1/	367	574	453	586	815	985
Refined 2/	1,096	2,165	2,097	1,743	2,655	3,113
Processed 3/	536	744	815	647	907	1,253
Other exports	817	808	939	944	879	1,171
Imports	2,752	3,322	3,586	3,682	3,922	5,251
Extracted 1/	558	1,072	907	1,019	1,064	1,521
Capital imports–energy related	421	552	735	664	1,064	863
Other	1,773	1,697	1,944	1,999	1,794	2,867
Energy related						
Investment income payments	173	243	438	413	295	561
Foreign direct investment (inward)	468	614	816	738	1,182	1,774
Energy exports, in percent of total	71.0	81.2	78.2	75.9	83.3	82.0

Sources: Central Bank of Trinidad and Tobago; Central Statistical Office; and Fund staff estimates and projections.

1/ Crude oil.
2/ This includes refined petroleum, liquefied natural gas, and natural gas liquids.
3/ This refers to all other energy related e.g., petrochemicals.

II. Labor Market Developments, 1994–2003[6]

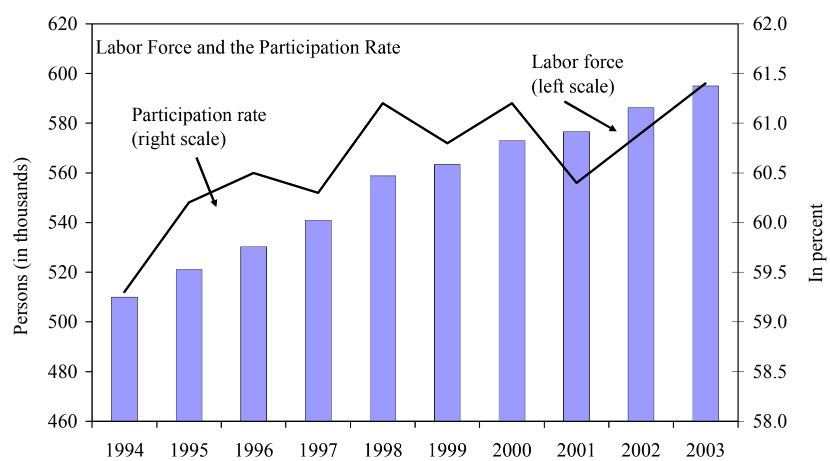
14. **Trinidad and Tobago has experienced 10 consecutive years of solid economic growth, driven mainly by the energy sector**. While the unemployment rate has fallen from a high of 18.4 percent in 1994 to 10.5 percent in 2003, the rate has hovered around 10 percent over the last three years. The problem remains therefore how to stimulate growth in the sluggish non-energy sector and in particular, to create sufficient sustainable employment.

A. Employment Trends

The participation rate

15. **One critical measure in the analysis of labor market trends is the participation rate**. The participation rate is defined as the ratio of the labor force to the non-institutional population[7] (NIP). In recent years, the participation rate has been increasing, i.e., a greater percentage of the NIP is participating in the workforce (Figure 1).

Figure 1. Trinidad and Tobago: Labor Force, 1994–2003



Source: Central Statistical Office.

16. **Movements in the participation rate reflect both cyclical and structural influences**. Theoretically, the participation rate has a strong positive relationship with

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[6] Prepared by Saqib Rizavi (WHD), based on a paper produced by the Central Bank of Trinidad and Tobago.

[7] The NIP is the working age population, that is, those persons who are over the age of 15 and under the age of normal retirement.

cyclical employment opportunities, usually called the 'encouraged worker' effect. The participation rate is also affected by social and cultural trends such as the changing age structure of the population and the social acceptance of women with children who work; the latter factor has resulted in increased female participation rates. In Trinidad and Tobago, the rate of growth in both the female labor force and female employment has exceeded that of their male counterparts in all but two years in the period under review.

Impact of the minimum wage

17. **The impact of the introduction of a minimum wage of TT$7 per hour in 1998, and its subsequent increase to TT$8 in 2001 is hard to assess, given other important changes in the labor market**. The minimum wage was directed mainly at providing a safety net for vulnerable workers services sector—for example, domestic workers, store clerks, etc. While the private sector expressed concern that the minimum wage would have an adverse impact on employment, it coincided with offsetting factors, notably the construction phase of two ammonia plants and Atlantic LNG Train I. Indeed, employment generation reached a peak (at 19,500 jobs) following the introduction of the minimum wage (Table 1). In these circumstances, it is difficult to isolate the impact of the minimum wage on employment.

Table 1. Trinidad and Tobago: Growth, Employment, and Unemployment, 1994–2003

Year	GDP Growth Rate		Employment (In thousands)	Unemployment Rate	
	Energy	Nonenergy		Standard Definition	Extended Definition 1/
1994	8.2	3.9	415.6	13.1	18.4
1995	0.1	4.2	431.5	12.0	17.2
1996	1.8	3.2	444.2	11.3	16.2
1997	-2.0	4.2	459.8	10.5	15.0
1998	5.4	4.4	479.3	9.9	14.2
1999	8.1	5.1	489.4	9.4	13.1
2000	12.4	4.9	503.4	8.5	12.1
2001	5.6	3.7	514.1	7.5	10.8
2002	13.5	3.5	525.1	7.3	10.4
2003	31.2	3.5	534.2	7.4	10.5

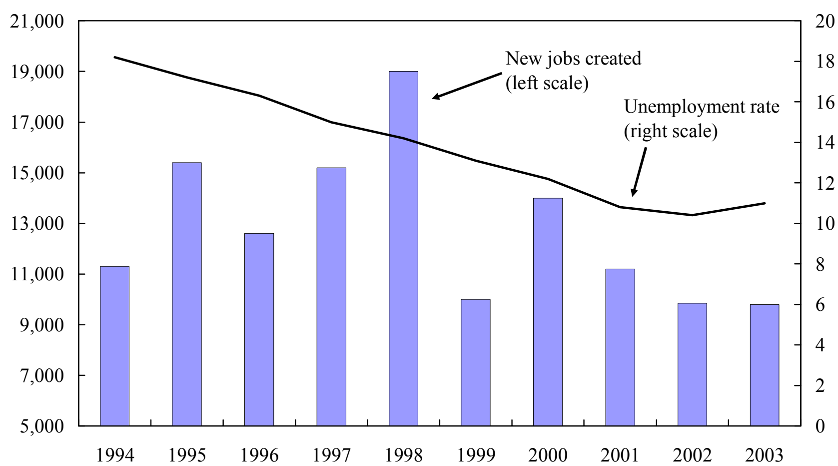
Source: Central Statistical Office.

1/ This is considered the most appropriate measure of unemployment for Trinidad and Tobago. It includes as unemployed persons who looked for work up to three months preceding the week of the survey.

Impact of CEPEP

18. **The Community Environment Protection and Enhancement Program (CEPEP) was launched in October 2002**. In the first phase of the program, 4,900 persons were employed in 110 companies. The latest data indicate that the number of people employed by the program has increased by 1,100. The employment generated by CEPEP is captured in the community, social, and personal services category of the quarterly employment survey. A close examination of this group shows that the increase of 5,200 in 2003 in the number of jobs created has been the largest in the past 11 years (Figure 2). The program has contributed positively to employment generation especially among the female, middle-aged workers with limited years of schooling.

Figure 2. Trinidad and Tobago: Labor Market Developments, 1994–2003



Source: Central Statistical Office.

Impact of the closure of the sugar company

19. **The closure of CARONI in 2003 did not have a significant impact on the overall rate of unemployment**. For the 9,000 workers which accepted the voluntary separation of employment package, the following occurred:

- Some workers were re-absorbed into the new entities created, such as the Sugar Manufacturing Company Limited and other private operating companies formed by ex-CARONI managers.

- Some workers left the labor force as more than 50 percent were over the age of 40 years.

- Other workers obtained employment in other sectors.

20. **While statistics show that employment in the sugar sector fell by 8,800 between the second and third quarters of 2003, the total number of unemployed persons rose by only3,700**. Discounting increases in the labor force, this would indicate that sufficient employment was generated in other sectors to compensate for the many of the job losses in the sugar sector.

B. Wage Trends

21. **In Trinidad and Tobago, wages are determined primarily by the collective bargaining process**. Table 2 shows that entry wages have lagged behind inflation, but industrial wages have generally increased in real terms and have grown particularly rapidly in the past three years. Average wage increases outside the energy sector have also been rising. The genesis of these increases has been the 15 percent awarded to public servants for a three-year period in 2003, which has served as a benchmark for wage negotiations in other sectors. While demand is outstripping supply in sectors such as finance and energy, the reverse is occurring in industries utilizing low/semi-skilled workers. Data from the Central Statistical Office reveals that approximately 45 percent of the workforce has either elementary or secondary education. If the trend in wage increases continues, especially if the increases are not justified by increases in productivity, then some sectors may lose their competitive edge. This can have a deleterious effect on future employment generation opportunities.

Table 2. Trinidad and Tobago: Wages and Prices
(In percent)

Year	Entry Wages	Industrial Wages	Average Wage Increases 1/	Inflation
1994	0.5	5.1	1.4	8.8
1995	1.9	4.1	2.7	5.3
1996	2.9	8.5	6.5	3.3
1997	1.9	4.6	-3.7	3.6
1998	2.4	5.1	3.2	5.6
1999	1.7	...	10.0	3.4
2000	2.4	9.0	-2.4	3.5
2001	1.5	9.3	10.0	5.6
2002	...	11.6	9.4	4.2

Source: Central Statistical Office.

1/ Excludes the energy sector.

C. Structural Issues

22. **With the unemployment rate hovering around 10 percent, the government has been attempting to correct a deficiency in the availability of skilled labor through increasing expenditure on education and training**. Some initiatives include: the new University of Trinidad and Tobago and other short/medium term programs to train youth in areas which may lead to sustainable employment. However, since the problem is one of a structural nature, one should not expect any significant downward movement in the unemployment rate in the near term, especially given the recent trend of rising participation rates.

D. Conclusion

23. **The high unemployment rate in Trinidad and Tobago reflects both an increase in the participation rate and structural issues that have limited job creation**. These include skills mismatches in the context of an increasingly knowledge-based growth, the capital-intensity of the energy sector, and wage pressures associated with large energy-related revenue inflows. While there have been positive developments over the last few years, particularly in the area of training and education, their impact on employment has been largely offset by job losses in the sugar sector, and possibly by an adverse impact of the minimum wage. The structural nature of the unemployment problem reinforces the need to focus on competitiveness-enhancing reforms in the labor-intensive sectors. In this context, it is important to design a reform agenda to enhance labor market flexibility.

III. External Competitiveness[8]

24. **In the context of the booming energy sector, competitiveness of the non-energy tradable sector has become an issue of concern**. Competitiveness of the non-energy tradable sector is of key importance since it is the main source of employment in the economy.[9] In fact, despite strong growth in the energy sector unemployment remains high, and production and export growth in the non-energy sector have been sluggish. Even though some indicators have to be interpreted with caution, the general conclusion seems to hold that competitiveness of the non-energy sector has faltered. This concern is reinforced by the expected large energy revenue inflows in the period ahead, which could further intensify the pressures on the real exchange rate.

A. Competitiveness Indicators

Exchange rate

25. **The Trinidadian dollar has remained broadly stable vis-à-vis the U.S. dollar over the last decade**. After a significant devaluation in April 1993, the Trinidadian dollar only depreciated by some 10 percent through 1997 in nominal terms, and has remained within a narrow band at around 6.3 TT$ per US$ since. However, Trinidad and Tobago's real effective exchange rate (REER) indicators suggest that external competitiveness has deteriorated over time. Figure 1 shows the multilateral REER as calculated by the IMF and the CBTT[10] and the bilateral REER with its major trading partner, the United States, based on consumer prices, and in the figure below the same set of indicators using producer prices. All indicators point to a real appreciation of the Trinidadian dollar. Even though the indices show some reversal in recent years—reflecting the depreciation of the euro against the U.S. dollar—the IMF and authorities' CPI-based REERs still remain some 12 and 16 percent above the 1997 level, respectively.

26. **The appreciation of the REER exchange rate can be mainly attributed to the nominal movements in the U.S. dollar rate and inflation rates in Trinidad and Tobago above international levels**. For instance, of the 12 percent REER appreciation since 1997, 7 percentage points

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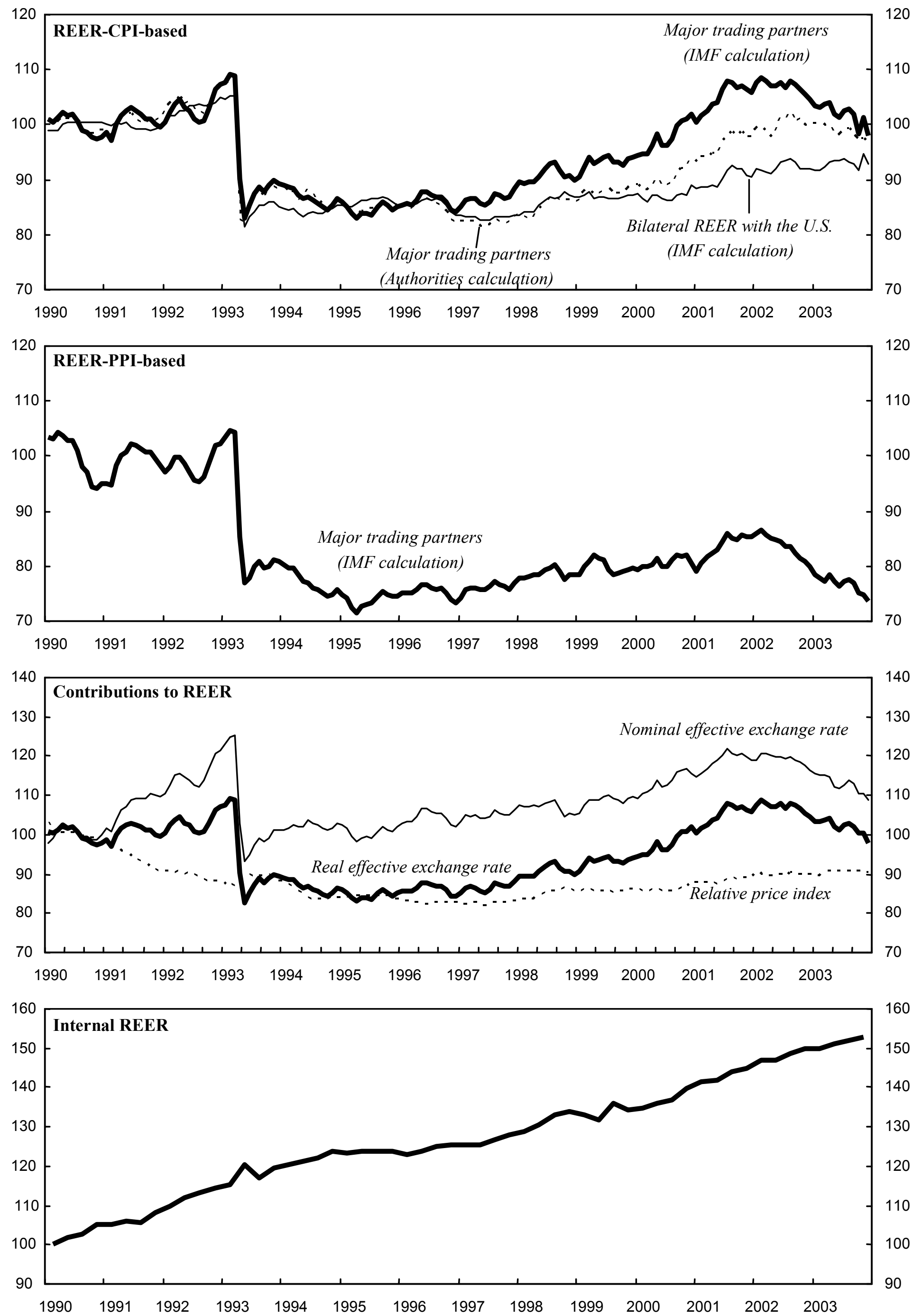
[8] Prepared by Stephanie Eble (WHD).

[9] Eighty seven percent of the total labor force work in the non-energy sector, 3 percent in the energy sector, and the remaining 10 percent are unemployed.

[10] This is calculated as a geometric average of bilateral exchange rates and consumer prices inflation between the Trinidad and Tobago dollar and other currencies, weighted by non-energy merchandise export shares with 1990 as base year.

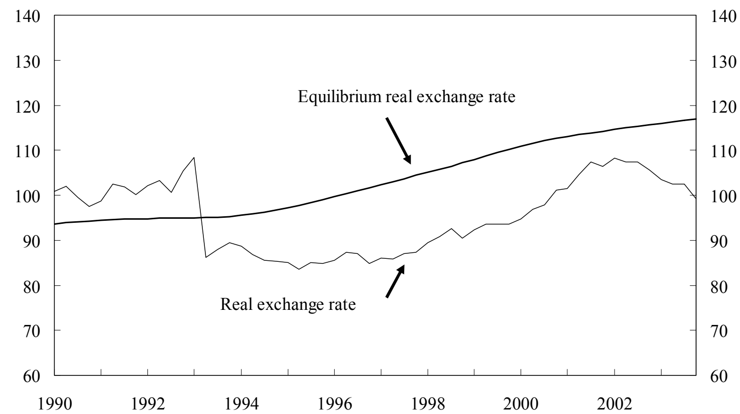
Figure 1. Trinidad and Tobago: Real Effective Exchange Rate Developments
(Index 1990=100)



Sources: IMF Information Notice System; and Trinidad and Tobago authorities.

can be attributed to the appreciation in the U.S. dollar rate against Trinidad and Tobago's major trading partners' currencies, and 5 percent to the higher domestic inflation. The strong impact of the U.S. dollar on the movements of the REER—at least in the short-term—reflects the nominal exchange rate fluctuations of the U.S. dollar, against which the TT$ has remained broadly stable in nominal terms.

Equilibrium Real Exchange Rate, 1990–2003
(Index 1990=100)



27. **However, real appreciation of the Trinidad and Tobago currency was accompanied by an upward shift in the equilibrium REER (EREER), reflecting a strengthening in the fundamentals**. This is supported by some stylized facts, in particular the increase in oil prices, which have added to the country's wealth. We estimate an econometric model following Edwards (1994) to assess the real exchange rate relative to its equilibrium level. The model of the equilibrium real exchange rate (EREER) includes as determinants oil prices (OIL), productivity differentials (PROD) and the real interest rate differential with the United States (INTEREST). Given that all the variables are I(1), we use the Johanson procedure to estimate the long-run cointegrating relationship between the variables.[11]

$$EREER = 0.96 * PROD + 1.43 * OIL + 1.57 * INTEREST$$

The EREER is then simulated using the estimated coefficients and the trend components of the fundamentals (computed with the Hodrick-Prescott Filter). The results suggest that the EREER has been steadily appreciating over the last decade, and that the REER is still below its long-term equilibrium rate, i.e., the currency remains undervalued, pointing toward further pressures to appreciate.

Unit labor cost

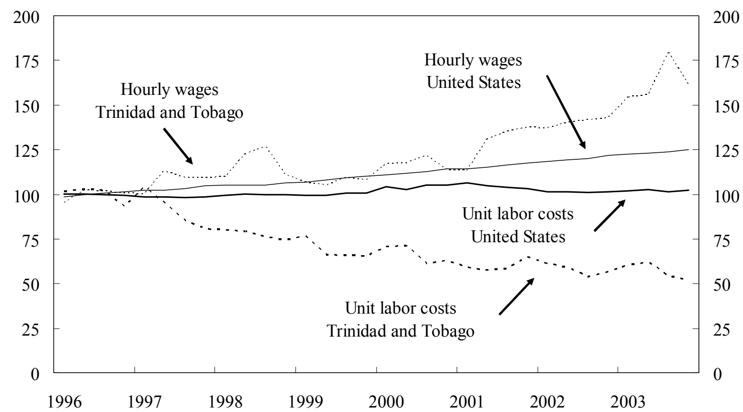
28. **Unit labor costs (ULC) in manufacturing (relative to the United States) have fallen markedly over the last years despite notable wage increases, suggesting an improvement in competitiveness**. A decomposition of the index by contributing factors

[11] The data set covers the period 1990–2003 and is based on quarterly observations.

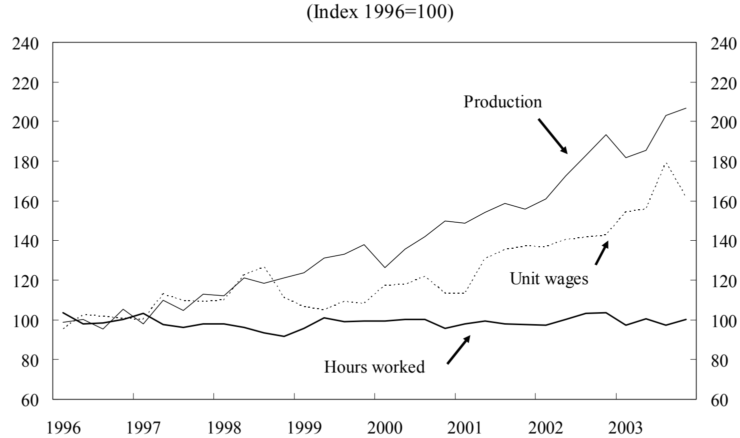
indicates that this largely reflects an increase in productivity, while at the same time real wages have increased and at a faster rate than in the United States.

29. **However, this indicator does not take account of changes in unit capital costs**. It only captures the relative costs of one production factor, i.e., labor. Changes in the prices of intermediate and capital goods that change competitiveness are not covered. Most importantly, if there is a substitution from labor to capital as a share of inputs, one would conclude that labor competitiveness has increased, while overall competitiveness may not have risen as the increase in unit capital costs is not captured.

Unit Labor Costs & Hourly Wages
(Index 1996=100)

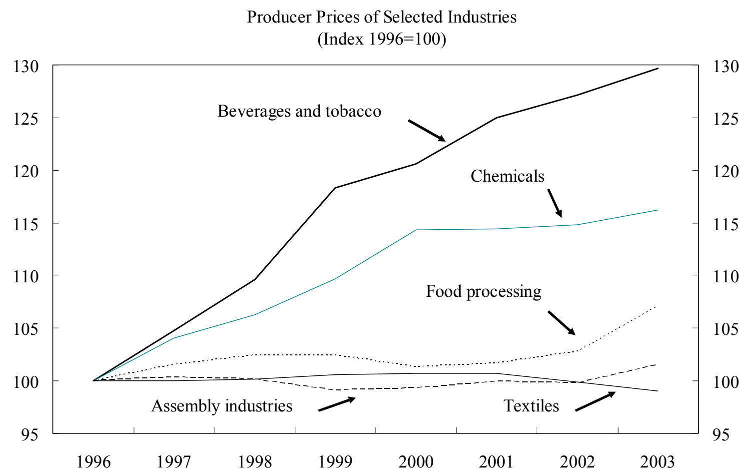


Unit Labor Costs-Contributing Factors
(Index 1996=100)



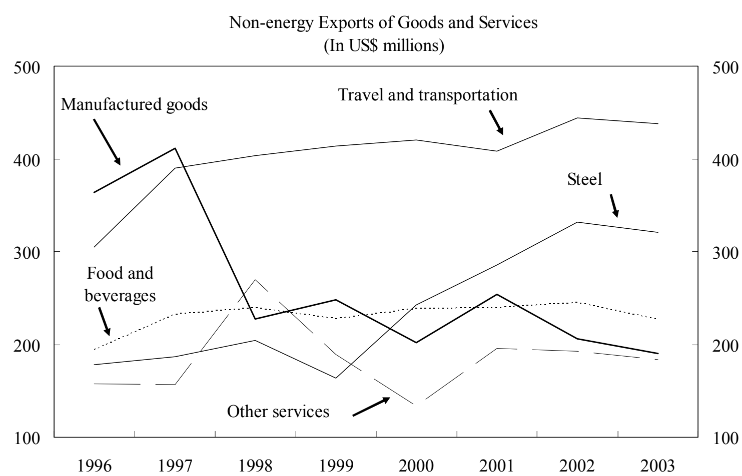
30. **Therefore, the ULC indicator has to be treated with particular caution in the context of Trinidad and Tobago's economic structure**. Economic developments are mainly driven by the oil and gas sectors, which are highly capital intensive, and therefore overall competitiveness is mainly impacted by the developments of unit capital costs. Since the manufacturing sector also includes some very high capital intensive energy-related upstream production, and has undergone significant structural changes over the last few years through large capital investment, capital costs are expected to have increased.

31. **In fact, producer prices for basic commodities suggest that overall production costs have increased**. For example, in the food, beverage, and wood industries production costs increased substantially during the period 1996–2003.



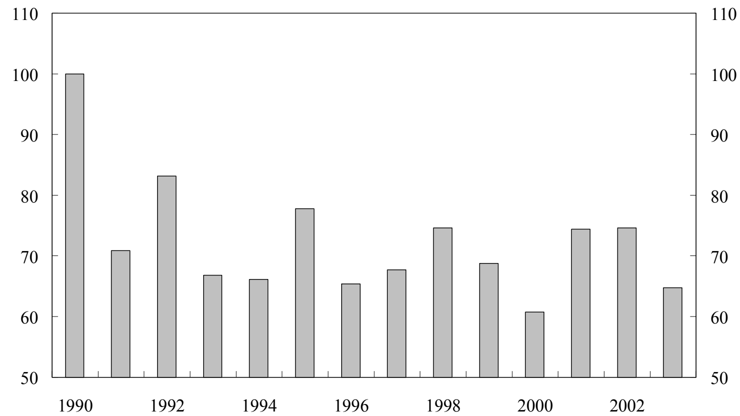
Market share

32. **Growth in exports of non-energy commodities and services over the last years has been modest, and exports even declined in 2003**. While non-energy exports modestly increased through 2002, they dropped in 2003 by some 8 percent, and across all categories. Mostly affected were manufactured goods (excluding steel), which declined by a cumulative 25 percent since 2001. Growth in exports of services during 1996–2002 was disappointing as well, and was negative by some 3 percent in 2003. At the same time, oil export growth has accelerated significantly. With new production facilities coming on stream, energy exports increased by some 45 percent in 2003, and are projected to increase by a further 35 percent in 2004.



33. **Nevertheless, Trinidad and Tobago has maintained its market share in its main export markets, which have experienced strong import growth in tandem with their cyclical recovery**. Trinidad and Tobago's main export markets for non-energy products are the CARICOM countries (70 percent) followed by the United States (26 percent) and the United Kingdom (4 percent). Trinidad and Tobago's non-energy exports as share of non-energy imports of these countries has fluctuated around the same value over the last few years.

Market Share in Export Markets
(Index of goods imports relative to goods exports)



Competitiveness index

34. **The Global Competitiveness Report ranks Trinidad and Tobago as an average performer in 2003, and has recently downgraded it (Table 1)**. While Trinidad and Tobago has outperformed other countries in the CARICOM region or of the FTAA, its competitiveness ranking (47) is significantly lower than either of its major trading partners, the United States and the United Kingdom. Also, Trinidad and Tobago has fallen in ranking across all indicators over the last two years—partly as a result of the emergence of new growth economies—which points to the need to make continuous improvements in order not to fall behind vis-à-vis other countries.

Table 1. Trinidad and Tobago: Competitiveness Ranking 1/

	2003	2002	2001
Growth competitiveness			
Trinidad and Tobago	47	42	37
Components:			
Macroeconomic environment	44	41	52
Public institution index	52	43	36
Technology index	45	43	25
Main trading partners			
United States	2	2	1
United Kingdom	15	11	11
Other countries in the region			
Costa Rica	49	49	43
Dominican Republic	58	56	52
Jamaica	63	57	60
FTAA 2/	56	55	55
Business competitiveness			
Trinidad and Tobago	52	44	31
Components:			
Company operations and strategy	54	44	27
Business environment	53	44	38
Main trading partners			
United States	2	1	2
United Kingdom	6	3	7
Other countries in the region			
Costa Rica	44	39	48
Dominican Republic	59	41	60
Jamaica	55	59	39
FTAA 2/	52	56	57

Source: World Economic Forum Competitiveness Indicators, 2003.

1/ Ranking of 80 countries with 1 as the highest ranking.
2/ Average ranking weighted by GDP.

35. **The real exchange rate and an ineffective use of public funds are identified as among the main competitive disadvantages of Trinidad and Tobago's macroeconomic environment (Table 2)**. Low scores were awarded for real exchange rate developments, governance issues, the large allocation of public funds to subsidies and public enterprises, and high bank spreads. Macroeconomic factors contributing positively toward competitiveness were the country's favorable prospects for growth, access to financing, and the strong fiscal position. It should be noted that the positive factors are spillovers from the energy boom, whereas the negative factors are of a structural nature. On other indicators, Trinidad and Tobago performs highest in technology, reflecting the spillovers from the energy sector. Nevertheless, its overall ranking in technology is not very high, reflecting strong reliance on FDI, low enrolment in tertiary education, and low research and development activity.

Table 2. Trinidad and Tobago: Macroeconomic Environment 1/

Advantages		**Disadvantages**	
Recession expectations	10	Real exchange rate	92
Access to credit	19	Diversion of public funds	72
Government surplus	21	Public trust of politicians	69
National savings rate	22	Distortive government subsidies	64
Country credit rating	42	Interest rate spread	62
		Distortive government intervention	46

Source: World Economic Forum Competitiveness Indicators, 2003.

1/ Ranking out of 102.

B. Policy Options to Enhance Competitiveness

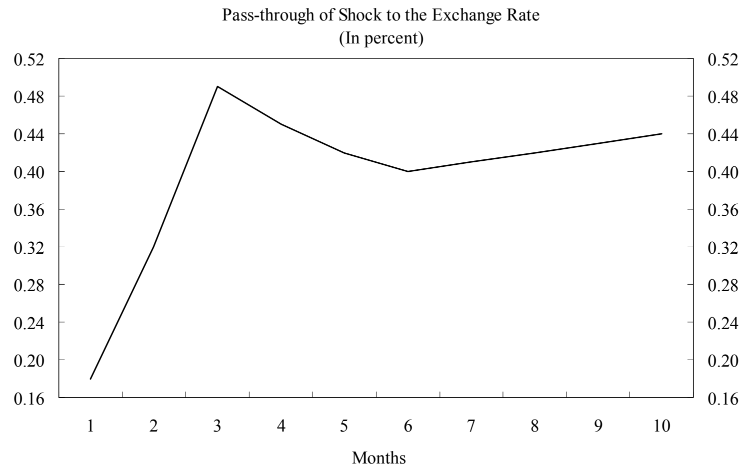
36. **The appropriate policy mix depends on Trinidad and Tobago's social preferences, institutional factors, its economic structures, and the external environment**. This section looks at various macroeconomic and structural policy options at hand to improve competitiveness. It discusses how they have been employed in the past, and their relative importance and potential effectiveness in addressing competitiveness issues in Trinidad and Tobago.

Exchange-rate policy

37. **The effectiveness of a devaluation on competitiveness depends on the exchange rate pass-through to domestic prices**. Whereas a change in the nominal rate has an immediate impact on competitiveness as it changes the relatives prices of tradables and nontradables, its long-lasting impact depends on the pass-through of the exchange rate on prices. This is likely to be higher the larger the share of imported goods in domestic consumption (McCarthy, 2000), the smaller the size of the economy since the country will be a price-taker in international markets (Kent, 1995), and the lower the level of competition in the domestic market, since there will be more room to pass on price increases. If the pass-through coefficient is very high, a depreciation of the exchange rate will not have much impact on competitiveness beyond the short term.

38. **Some stylized facts point at a high pass-through**. Trinidad and Tobago is a very small, open economy with a ratio of imports and exports to GDP of 90 percent, and imports to domestic consumption of 55 percent. This implies that the domestic producers are price-takers in international markets. Most importantly, strong labor unions are unlikely to accept a sustained fall in real wages.

39. **The pass-through coefficient is estimated at some 60 percent**. The statistical pass-through during the 1993 exchange rate adjustment was 50 percent after 6 months. Estimating the pass-through for the more recent period 1994–2003, using a three variable recursive, suggests a cumulative pass-through of some 55 percent after three months.[12]



40. **The increasing openness of the Trinidadian economy gives rise to an increasing preference for maintaining a stable exchange rate**. However, nominal exchange rate stability may hurt competitiveness over the medium term if domestic prices rise above international levels. This would put pressures on the real exchange rate and constrain the growth and employment potential. Indeed, in the period 1998–2003, CPI inflation in Trinidad and Tobago was persistently above that in the United States, causing a real appreciation against the U.S. dollar of some 14 percent.

Fiscal policy

41. **Fiscal policy plays a key role in controlling aggregate demand**. Energy revenues in FY2002/03 amounted to 41 percent of total government revenues or 11 percent of GDP, compared to 7 percent of GDP and 31 percent of government revenues in FY2001/02. Given the large energy revenue inflows to the government, and their high volatility, fiscal policy plays a key role in managing their impact on aggregate demand through smoothing government spending on non-tradables, i.e., by running a countercyclical fiscal policy.

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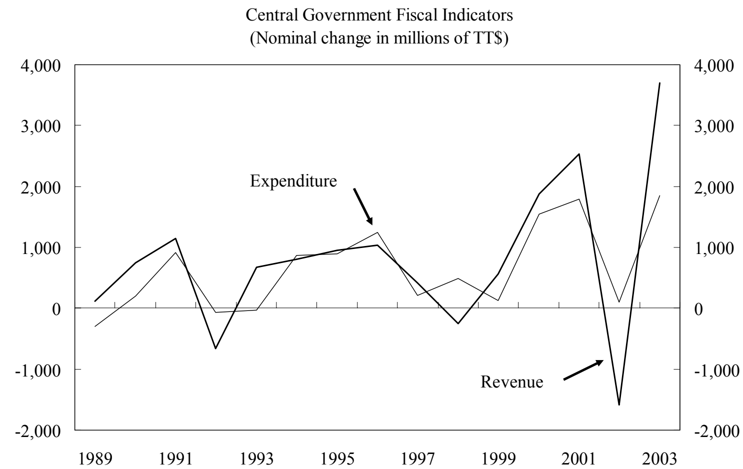
[12] The variables used are the exchange rate of the Trinidad and Tobago dollar to the U.S. dollar, domestic consumer prices, and the production index as a proxy for aggregate demand. The data are quarterly and the sample period covers 1994–2003. The results were not sensitive to the ordering of the variables.



42. **However, over the last decade, fiscal policy in Trinidad and Tobago has been procyclical**. The relationship between expenditures and revenues has been strongly positive (correlation coefficient of 0.82), with expenditures following closely the revenues available. This trend has even been more pronounced since 1999 (correlation coefficient of 0.93). High volatility in energy revenues (standard deviation of 2.7) was translated into a high volatility of expenditure (standard deviation of 2.2).

43. **Appropriate fiscal rules and procedures supported by a well designed revenue stabilization fund could be key in minimizing Dutch disease effects**. A key policy requirement is prudent fiscal management that allows for fiscal surpluses during times of large energy-related revenues. The revenue stabilization—under its current design fund—envisages setting aside resources when the oil revenues are above budgeted amounts,[13] which would be used to build up assets abroad. To be effective, however, this requires that the budget is drawn up on assumed energy revenue inflows that are consistent with containing expenditure on non-tradables and avoiding an overheating of the economy.

Structural policies

44. **The government has identified a broad-based medium-term structural reform agenda that aims at improving the long-term fundamentals of the economy and reducing the costs of doing business**. Recent policy initiatives by the government cover:

- **Public enterprise reform**. The loss-making sugar company was restructured in 2003 to improve its competitiveness. Steps are being taken to strengthen governance and transparency in the other public enterprises.

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[13] The current rules stipulate that deposits and withdrawals to the Revenue Stabilization Fund (RSF) are to be made when quarterly energy tax revenues and royalties exceed or fall below the quarterly revenues anticipated in the budget by 10 percent of more. Deposits should be at least 67 percent of the difference between realized and budgeted revenues, and withdrawals are to be equal to the lesser of: (i) the petroleum taxation deviation for the quarter/year under reference; and (ii) 25 percent of the balance of the RSF at the beginning of the quarter/year.

- **Financial intermediation**. The CBTT reduced reserve requirements by 4 percentage points in September 2003 (to 14 percent) with a schedule to bring them down to 9 percent by mid-2005. This first reduction resulted in a decline of lending rates by 200 basis points.

- **Telecommunications**. In the telecommunication sector, a new regulatory body (the Telecommunication Services Authority) has recently been set up, and the local telecommunication services market is being liberalized.

- **Transportation**. Plans to restructure the Port Authority are at an advanced stage. This would entail majority private sector participation in the cargo handling operations under a new company, while rationalizing other port activities.

- **Education**. The government has established a new university and is increasing the availability of skilled labor through increasing expenditure on education and training.

C. Conclusion

45. **External competitiveness in the non-energy sector in Trinidad and Tobago has deteriorated over the recent past and is a concern going forward, particularly in the context of the continuing energy boom**. Various indicators of external competitiveness have been examined, including the real effective exchange rate, unit labor costs, and survey based indicators. While the analysis of the REER suggests that it has remained in line with its fundamentals, and unit labor costs have been declining relative to the United States, declining non-energy exports, high capital costs, and wage pressures suggest that competitiveness has been adversely affected. In view of the upward pressure on the real exchange rate from large energy-related inflows, determined pursuit of structural reforms, especially of the labor market, will be critical to promote employment and non-energy sector growth.

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IV. Monetary and Exchange Rate Policy[14]

A. Introduction

46. **The primary objective of monetary policy in Trinidad and Tobago is to achieve a low and stable rate of inflation**. Monetary policy, therefore, seeks to maintain a suitable level of liquidity, in the context of domestic and external developments, that would encourage economic activity without promoting inflationary pressures. Within this context, the Central Bank of Trinidad and Tobago (CBTT) views a stable foreign exchange market, especially with the government being the major earner of foreign exchange, as critical to keeping inflation low.

47. **This chapter discusses monetary and exchange rate policy in Trinidad and Tobago**. Section B briefly describes the institutional setting and economic structure within which monetary and exchange rate policy is conducted. Section C outlines the framework under which monetary policy is formulated and implemented. Section D reviews the evolution of monetary and exchange rate policies. Section E concludes with some brief comments on the effectiveness of monetary and exchange rate policy in Trinidad and Tobago and future prospects.

B. Background

48. **The financial system in Trinidad and Tobago is quite diversified, with a wide mix of bank and nonbank financial institutions**. These include trust and mortgage finance companies, merchant banks, finance houses, insurance companies, development banks, thrift institutions, mutual funds, credit unions, venture capital companies, *bureaus de change,* and a number of brokerage firms. The financial system also includes a specialized mortgage institution, a Deposit Insurance Corporation, the National Insurance Board, and a Stock Exchange. Commercial banks are the major players with just under half of the total assets of the financial system.

49. **The banking system is comprised of six commercial banks, two of which are foreign subsidiaries of international banking groups, while the remaining four are majority or fully locally-owned (two of which have established a commercial presence in various Caribbean territories)**. Most of the commercial banks have become *universal banks,* offering a wide range of financial products and services. While commercial banks remain the single largest group of financial institutions, by various standards—including assets, loans, and/or deposits—the share of finance houses and merchant banks in total assets has been growing in recent years (Table 1).

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[14] Prepared by Carlene Y. Francis (WHD).

50. **The foreign exchange market has some unique features, which include**:

- A small number of major foreign exchange suppliers with earnings derived from the energy sector;
- The Central Bank is an important supplier of foreign exchange to the market, as government receives energy-related taxes and royalties in foreign currency, and sells these to CBTT;
- Six licensed traders (all commercial banks) with activity dominated by one or two major players; and
- Very little activity from bureaux de change, as earnings from the tourism sector are relatively low.

51. **In April 1993, exchange controls on current and capital transactions were abolished and the Trinidad and Tobago dollar was allowed to float**.[15] Under the floating regime, which lasted for about four years, the TT dollar depreciated substantially. However, since 1997, the exchange rate has been de facto pegged at about TT$6.3 per U.S. dollar. While, in principle, the exchange rate became market-determined, the lumpiness and volatility of foreign exchange inflows, coupled with market imperfections, required that special institutional arrangements be put in place to govern the operations of the foreign exchange market. These included:

- An Agreed Minute on the operations of the market—key elements of which were the guidelines on the daily setting of buying and selling rates, as well as the upper limit on the spread between the buy and sell rates. This cap ensured that no single foreign exchange dealer could make "super profits" on foreign exchange transactions;
- A Code of Conduct for market participants—this allowed for an appropriate dispute mechanism among foreign exchange traders; and
- A Sharing Arrangement— given the lumpiness of inflows from a few large earners, there was concern that the two largest players would dominate the foreign exchange market, and cause undue volatility in the exchange rate. This arrangement allowed foreign exchange purchases to be shared equally among dealers.

52. **The CBTT has a key role in the foreign exchange market in Trinidad and Tobago**. As the central bank is the major recipient of foreign exchange, it must supply the

[15] The Exchange Control Act (1970) was repealed in 1993.

market with foreign currency to avoid large reserve increases that could be difficult to sterilize.[16] While some central banks in similar positions seek to establish rules for intervention that limit the effect on the exchange rate, in recent years the CBTT has maintained a de facto peg and supplied foreign exchange to the market as required. There is a tacit agreement among market participants that the exchange rate should not move outside of a notional band.

53. **With over 30 percent of the budget financed from energy-related taxes, paid in foreign currency and sold to the CBTT, the non-energy fiscal deficit is a major source of liquidity in the banking system**. The cumulative fiscal injection from this deficit was usually around TT$500 million (2.7 percent of 1997 GDP) per annum.

C. Framework Underlying Monetary Policy

54. **The framework for monetary policy originates in the Central Bank of Trinidad and Tobago (CBTT) Act (1964)**. The Act (amended in 1994) defined the Bank's purpose as "...the promotion of such monetary, credit and exchange rate conditions as are most favorable to the development of the economy of Trinidad and Tobago." In pursuit of this goal, the Bank conducts monetary policy to achieve a low and stable rate of inflation. Given the sensitivity of domestic prices to exchange rate movements, the central bank views the maintenance of an orderly foreign exchange market as an important factor in the formulation and implementation of monetary policy.

55. **The financing of the budget is a key factor in the formulation and conduct of monetary policy, as this is a major source of liquidity in the system**. Once the budget is approved, the CBTT makes an estimate of how much open market operations (OMOs) would be required to manage liquidity based on fiscal needs, and a confluence of other factors, which include current and projected macroeconomic developments, particularly in the energy sector, and the timing of government bond issues. The CBTT's estimate of OMOs is approved by the Minister of Finance as part of the budgetary process.

56. **Historically, the framework for monetary policy may be separated into two distinct periods—prior to and after 1996**. Prior to 1996, monetary policy was conducted through direct instruments—mainly reserve requirements, the rediscount rate, and selective credit controls, supported by moral suasion. Since 1996, open market operations, mainly through outright sales of short-term government securities (largely three-month treasury bills), have became the major monetary policy instrument. While there is currently no formalized operational framework for the execution of monetary policy, the CBTT has in place a system of primary dealers (all commercial banks) through which open market

[16] The CBTT's sales of foreign exchange are based on ratios, ranging from 1 to 28 percent.

auctions are transacted.[17] OMOs are conducted to influence the level of interest rates in the short term money market. The central bank, therefore, maintains daily contact with market participants to obtain information on market activity, and to apprise them of existing and/or projected levels of liquidity and other developments, including credit conditions.

57. **The central bank introduced a new framework in May 2002 based on the use of its repo rate to signal the stance of monetary policy**. The main features of this new arrangement are outlined in Box 1 below. When the new framework was introduced, the CBTT resolved to keep excess liquidity at low levels in order to enhance the effectiveness of the repo rate as a policy signal. Consequently, over the 12-month period ending October 2002, the CBTT sold almost TT$1.7 billion interest-bearing treasury notes, which resulted in a substantial reduction in the Special Deposit Account. Since then, the CBTT has conducted OMOs almost daily.[18]

58. **The impact of open market operations in Trinidad and Tobago is felt mainly through short-term interest rates, as the value of the currency has remained basically unchanged for several years**. Open market operations, through sales of short-term government securities, influence short-term interest rates through changes in liquidity. Appropriately timed intervention in the foreign exchange market, through sales of foreign currency, also serves to reduce excess liquidity in the banking system. Short-term interest rates are also affected through changes in reserve requirements. In October 2003, the CBTT announced a phased reduction in the reserve requirement for commercial banks from 18 percent to 9 percent by March 2005. In order to offset the impact of this monetary injection on the economy, special issues of government bonds will continue to be issued simultaneously to absorb the resources released.

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[17] Under a new expanded auction system for government securities, introduced in July 2004, the primary dealer arrangement was expanded to include eligible nonbank financial institutions to better facilitate open market operations, and to encourage the development of a secondary market for government securities.

[18] Commercial banks hold balances in excess of reserve requirements in a special deposit account at the CBTT.

Box 1. Trinidad and Tobago: New Framework for Monetary Policy

On the first Thursday of each month, the CBTT announces the level of its key policy interest rate, repo rate—the rate charged to commercial banks for collateralized overnight loans—initially set at 5.75 percent in May 2002.

Three other CBTT interest rates are tied to the repo rate:

Reverse repo rate—paid on occasion that CBTT offers to take overnight funds from the banks, set at repo rate less 50 basis points;

Discount rate—rate at which banks borrow to cover an unexpected deficit following the daily check clearing, set at the repo rate plus 200 basis points;

Special deposit rate—rate paid on balances that commercial banks hold in excess of the statutory reserve requirement, set at the repo rate less 200 basis points.

The repo and reverse repo rates define the CBTT's trading band, within which or near which the interbank money market would normally trade. The discount rate provides a ceiling, and the special deposit rate, a floor, which reinforce the policy range for the interbank overnight rate.

D. Evolution of Monetary and Exchange Rate Policy

59. **Institutional arrangements in the immediate post-Independence era left little or no room for an active monetary policy in Trinidad and Tobago**. The country remained under the Sterling Area arrangements, the key elements of which were free convertibility and maintenance of a fixed parity with sterling. By the mid-1970s, the importance of sterling in Trinidad and Tobago's external transactions had been long superseded by that of the U.S. dollar. This, together with a steep and steady depreciation of the international value of sterling, led to the breaking of the sterling peg in May 1976**,** in favor of a link with the U.S. dollar at a rate of TT$2.40=US$1.

60. **From 1974–82, the economy of Trinidad and Tobago performed extremely well, reflecting the sharp increase in oil prices**. As oil prices subsequently began to weaken and economic activity declined, resulting in large fiscal and external payments deficits, economic policy shifted toward stabilization. Within this context, the CBTT raised the discount rate from 6.00 to 7.50 percent in 1983, and set the CRR at 17 percent. However, as economic activity continued to decline, the CBTT eased monetary policy slightly in 1986 by (i) lowering the CRR from 17 percent to 15 percent, (ii) negotiating a reduction in commercial bank interest rates; and, (iii) relaxing installment credit guidelines.

61. **The recession in 1983, compounded in 1986 with the collapse of oil prices, led Trinidad and Tobago to adopt an IMF-sponsored stabilization and structural adjustment program in 1988, which included the reform of the financial system**. This heralded a process of reform and liberalization of the economy, which culminated into a

shift to a flexible exchange rate regime in 1993 and correspondingly, a fundamental change in the conduct of monetary policy. The focus of monetary policy shifted to short-term liquidity management, through the use of market-oriented policy instruments, and away from direct instruments of monetary control. The CBTT used open market operations, supported by appropriately-timed intervention in foreign exchange market, to manage liquidity.

62. **During 1994–98, the central bank's sales of foreign exchange were limited, though there were periods of greater need for such sales, associated with the lumpiness in foreign currency inflows from the energy sector**. During 1993–95**,** the CBTT's sales in the foreign exchange market amounted to US$42 million, compared to purchases from commercial banks of US$150 million. By end-1996 this was reversed, with the CBTT selling US$102 million to the market, reflecting in part uncertainties associated with the change in political administration.

63. **As the demand for foreign exchange rose toward the end of the nineties, the CBTT became more active on the selling side of the market, which had the effect of stabilizing the exchange rate**. Recent years have been marked by a shift in the capital account of the balance of payments toward higher investment outflows.[19] In 2003, the CBTT sold almost US$500 million to the market, up from US$309 million in 2002 (compared to a small net purchase from commercial banks in 2001).

64. **Over the last two years, the CBTT has pursued an accommodating monetary policy in the context of weak credit demand, slow growth of the non-energy sector, low inflation, a strong balance of payments, and record low international interest rates**. The benchmark repo rate was reduced to 5.25 percent in September 2002 from 5.5 percent. Short-term money market rates, and commercial bank interest rates, have moved broadly in line with the changes in the repo rate. In September 2003, the repo rate was again lowered to 5 percent. In a further effort to bring interest rates down and in keeping with the announced phased reduction in CRR, reserve requirements were reduced from 18 percent to 14 percent in October 2003.[20] These actions led to a decline in interest rates, and contributed to a sharp increase in credit to the private sector of 19 percent for the 12-month period ending April 2004.

[19] Related to increased overseas investments by the domestic private sector, and higher levels of foreign currency-denominated bond placements by regional governments and corporations.

[20] The CBTT lowered reserve requirements further to 11 percent in September 2004.

E. Conclusion

65. **Monetary and exchange rate policy in Trinidad and Tobago has been fairly successful in containing inflation (with increases in retail prices averaging about 4½ percent over the last 10 years), albeit above that of its major trading partners**. Excluding food prices, which tend to be volatile, core inflation averaged some 1 percent a year. Given the structure of the foreign exchange market and the potential for wide fluctuations in the exchange rate, associated with highly volatile oil prices, the central bank had to supply the market with foreign exchange to cover periodic shortfalls. This has resulted in an orderly foreign exchange market, and a stable exchange rate, considered crucial for keeping inflation low in a system dominated by foreign exchange inflows to the government.

66. **The central bank's expanded monetary policy framework has improved transparency and the transmission of monetary policy signals**. The market appears to recognize the repo rate as the key indicator of the prevailing monetary policy stance, and short term rates do appear responsive to changes in it.

67. **The authorities have moved to strengthen monetary policy further with the introduction of an expanded auction system in July 2004**. The system now includes long-term government securities, and a broader primary dealer arrangement to include nonbank financial institutions in the open market auctions. This is intended also to promote the development of a secondary market in government securities, and is expected to further enhance the efficacy of monetary policy The move toward harmonization of reserve requirements across financial institutions will further support these objectives.

Table 1. Trinidad and Tobago: Selected Financial and Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 1/
			(In percent of GDP)				
Commercial banks							
Total assets	69.5	67.5	64.1	69.6	72.8	65.7	60.3
Net credit to public sector	6.4	6.1	3.7	4.8	6.4	4.7	3.1
Credit to private sector	28.0	28.0	26.0	25.6	26.7	23.1	22.4
Trust and mortgage companies							
Total assets	12.9	15.5	17.8	16.3	17.2	17.2	16.2
Net credit to public sector	1.9	1.7	2.5	1.6	1.7	2.4	2.2
Credit to private sector	9.0	10.0	11.4	11.3	11.2	11.0	9.2
Finance houses and merchant banks							
Total assets	10.5	11.5	9.3	11.4	12.4	12.6	12.6
Net credit to public sector	0.9	0.9	0.5	0.4	0.7	0.5	0.4
Credit to private sector	3.4	5.0	3.6	5.2	4.5	3.9	4.7
			(In percent)				
Inflation							
End-of-period	5.6	3.4	5.6	3.2	4.3	3.0	3.1
Average	5.6	3.4	3.5	5.5	4.2	3.8	...
Interest rates							
Three-month treasury bill	11.9	10.5	10.5	8.3	4.8	4.8	4.8
Repo rate 2/					5.3	5.0	5.0
Basic prime rate	17.5	17.3	16.5	15.0	12.4	9.5	9.5
Monetary aggregates							
Base money growth	9.8	6.5	7.9	12.5	-3.9	5.3	-10.9
M3 growth	-7.4	5.6	5.9	12.6	2.7	2.0	8.4
Reserves requirement ratio							
Commercial banks	21.0	21.0	21.0	18.0	18.0	14.0	11.0
Nonbank financial institutions	9.0	9.0	9.0	9.0	9.0	9.0	9.0
Memorandum items:							
Exchange rate							
TT$ per US$	6.3	6.3	6.3	6.2	6.3	6.3	6.3
REER (depreciation -)	1.9	4.8	8.2	3.9	-1.1	-6.5	1.3
Real GDP growth	7.8	4.4	7.3	4.0	7.1	13.1	6.2 3/
Nominal GDP (TT$ billions)	38.1	42.9	51.4	54.8	55.1	66.2	79.0 3/
Gross official reserves (US$ millions)	761.9	942	1,405	1,876	1,924	2,258	2662 3/

Source: Trinidad and Tobago authorities.

1/ Most recent data available.

2/ The repo rate (introduced in May 2002 at 5.75 percent) is the signal rate of the central bank's monetary policy stance.

3/ Fund staff estimates.

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V. Structural Reforms[21]

68. **The government of Trinidad and Tobago has outlined a wide-ranging structural reform agenda, aimed at addressing competitiveness issues, fostering economic diversification, promoting employment, and reducing poverty**. These reforms are being pursed and formulated in the context of the government's Vision 2020 initiative, which is geared toward achievement of developed-country status by the year 2020. The broad reform elements pertain to the central government, the public enterprises, the financial sector, and the supply side of the economy.

Central government

69. **Greater efficiency on both the revenue and the expenditure side of the budget are viewed as needed to improve both competitiveness and income distribution**. On the revenue side, the government sees scope for tax policy enhancements and improved revenue generating capacity. In this context, it has approved the establishment of an independent revenue authority that will consolidate the operations of the current Inland Revenue Division and Customs Department. Concurrently, the government will implement a tax reform with regard to both the energy and non-energy sectors. It is at an advanced stage of preparation of a new energy tax regime, aimed at better capturing the rents from natural gas while still providing the necessary incentives for investment and exploration. Such a regime is expected to go into effect concurrently with the FY 2004/05 budget. In addition, the government intends to undertake a comprehensive reform of the non-energy tax regime envisaged to take effect in FY 2005/06. To this end, it has requested technical assistance from the IMF's Fiscal Affairs Department.

70. **Regarding the expenditure side of the budget, the government intends to reform the procurement regime and adopt output budgeting**. In June 2004, the government issued a green paper for public discussion, detailing a plan for the reform of the procurement regime. The key proposal is to adopt a decentralized system based on best international practices of transparency and accountability. Output budgeting, which is expected to be introduced in the context of the FY 2005/06 budget, will aim to improve the delivery of services by requiring ministries and agencies to submit their budget proposals along with a clear specification of targets and related costs. Nearly 1,000 officials have been trained in output budgeting in various ministries, including the core staff of the Treasury and the Budget Division. In addition, the government intends to transition over the next two years to a computerized Integrated Financial Management Information System, aimed at strengthening the budgeting, monitoring, and control of government transactions and debt management.

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[21] Prepared by Saqib Rizavi (WHD).

71. **The government is in the process of designing a reform of the pension system**. This will include a move to a fully funded contributory pension scheme for government employees; integration of Old Age Pension with the National Insurance Scheme (NIS), in the context of a deeper reform of the NIS; and improvement of the legal and regulatory framework for private pension schemes.

Public enterprises

72. **In June 2003, the government closed down the state-owned sugar company, CARONI 1975, in the context of a restructuring of the sugar industry**. The sugar cane production and refining operations of CARONI had become unprofitable, which had required substantial government transfers, including for servicing some of debts of the company. The restructuring of the sugar industry entailed the devolution of sugar cane production to the private sector and the establishment of a new government-owned company, the Sugar Manufacturing Company Limited (SMCL), dedicated solely to sugar manufacturing. In order to mitigate the impact of the restructuring on the labor force of nearly 9,000 (including the former sugar cane farming segment), the government is implementing a safety net scheme, including severance payments, training, and priority to former CARONI workers to lease state lands for agricultural and housing purposes.

73. **The government is reviewing the corporate governance framework for the public enterprises, with a view to ensuring adherence to appropriate standards of governance, transparency, and accountability**. To strengthen monitoring of the public enterprises, the ministry of finance has developed a range of guidelines relating, inter alia, to contracts, executive compensation, litigation procedures between state agencies, and borrowing authority. In the interest of transparency, the state enterprises have been mandated to publish, in at least one major daily newspaper, a summary of the audited financial statement, within four months of the end of their financial year. They are also to publish a summary of the unaudited half-yearly statements within two months of the mid-year date. Concurrently, the authorities are reviewing the legislative framework governing the public enterprises. In this connection, a committee is working toward the development of Standard By-Laws for State Agencies; a Code of Best Practice is also under consideration.

Financial sector

74. **Trinidad and Tobago has emerged as the main regional financial center**. In view of the increasing financial flows through the country's financial sector to the region, the authorities see a heightened need to upgrade the related supervisory and regulatory framework. In this context, the central bank's supervisory role was expanded, in May 2004, through an amendment to the Insurance Act that transferred responsibility to supervise insurance companies, insurance intermediaries, and pension plans, from the Office of the Supervisor of Insurance (in the ministry of finance) to the Central Bank of Trinidad and Tobago. This transfer of supervisory authority is expected to enhance coordination in the oversight of the financial system through greater consistency in supervision over similar financial services and products. In order to upgrade the regulatory and supervisory

framework for the financial system to a level consistent with its increasing regional role, the authorities are developing a broad legislative agenda, including amendments to the Financial Institutions Act, Insurance Bill, and the Securities Industry Act. Regulations governing credit unions will also be strengthened.

75. **The authorities are taking steps to deepen the capital market**. In this context, and also with the aim of improving public debt management, in July 2004 the central bank introduced an expanded auction system for government securities. The new system incorporated the provision of noncompetitive bids of up to TT$20,000, which seeks to encourage participation of small investors. Meanwhile, work is underway at the ministry of finance to strengthen the Public Sector Finance Management Unit, including through the adoption of a debt management and financial analysis system.

Supply side reforms

76. **The telecommunications sector is viewed as key for external competitiveness**. In July 2004, the Telecommunications Act was amended to pave the way for full liberalization of the sector. The amendment allows competition and removes the monopoly of the Telecommunication Services of Trinidad and Tobago. A new regulatory body for the telecommunications sector, the Telecommunication Services Authority, has already been established, and is developing a broadcast code for the liberalized sector.

77. **To improve the efficiency of the port operations, the government is at an advanced stage of planning to restructure the Port Authority of Trinidad and Tobago**. This restructuring would entail majority private sector participation in the cargo handling operations under a new company, while rationalizing other port activities. Legislation to support the proposed restructuring plan has already been drafted. Discussions are also taking place with the labor unions to work out a manpower separation plan similar to that applied successfully in the case of the now closed sugar company CARONI 1975. In addition, the Regulated Industries Commission is implementing a strategic plan whereby the public utilities (Trinidad and Tobago Electricity Company and Water and Sewage Authority) will be given incentives to rationalize their operations in line with international employment and cost standards. In this context, it is envisaged that Water and Sewage Authority move fully to a metering-based tariff system over the medium term.

78. **The supply-side measures are being supplemented by a shift in the composition of the Public Sector Investment Program, away from direct government involvement in productive activities toward economic infrastructure (e.g., roads) and social spending (e.g., education and health)**. In this context, the government is developing a new industrial estate dedicated to the promotion of high-technology industrial development. This development is expected to benefit from synergies with the new University of Trinidad and Tobago, which will be located in the same estate.