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Interest Rates: How Low Can They Go?

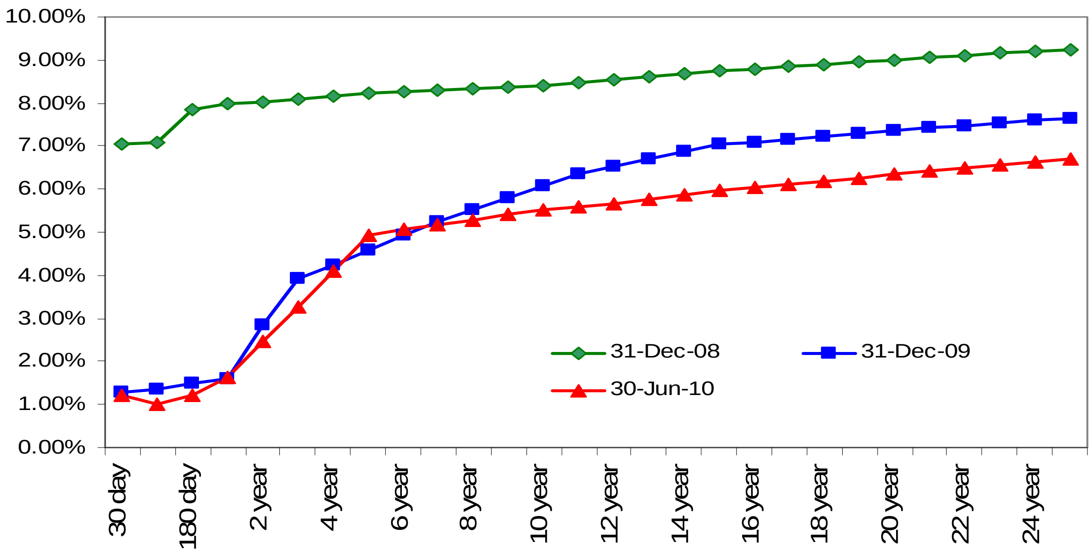
Over the past two years, interest rates across the world sank to record lows as policy makers sought to provide support to the stricken economies reeling from the fallout from the financial market crisis. The aggressive pace of interest rate cuts was validated by the dramatic slowdown in aggregate demand and the virtually frozen credit markets. Under such circumstances, price levels plunged, resulting in widespread deflation, which provided an even stronger case for low interest rates. In the advanced economies such as the US and the European Union, the problem of declining price levels still exists even as the global economy gradually pulls out from the economic doldrums. However, in some countries where demand has rebounded strongly, inflation has become a concern. This is the case for countries like Brazil and China, which are actually at risk of 'overheating'. These countries have in fact increased their policy interest rates in an attempt to rein in domestic demand and inflationary pressures.

In Trinidad and Tobago, the inflation rate has started to edge up once again, after hitting a low of 1.3% in 2009. In the 12 months to June 2010 headline inflation has yet again, crossed the 10% psychological threshold reaching 13.7%. This compares to a rate of 3.7% at the start of 2010. The main impetus for this dramatic uptick in prices was the exorbitantly higher price of food, which increased 31% in June. On a month over month basis, food inflation rose to 9.6%, which according to the Central Bank of Trinidad and Tobago (CBTT) is the highest monthly rate of increase in well over a decade. The higher prices were mainly a result of supply constraints, given the extreme weather patterns experienced over the past few months, from the severe drought conditions earlier this year to now flooding in some of Trinidad and Tobago's 'food baskets'. On a positive note, core inflation, which tends to be less volatile and a better indicator of underlying inflation pressures remained unchanged at 4.3%. The stability in core inflation was underpinned by benign producer prices as well as building materials.

Between March 2009 and January 2010, the central bank slashed the repo rate from 8.75% to 5%, and has since maintained the rate at that level in an attempt to shore up economic growth. Indeed, while interest rates have fallen significantly, credit expansion has been anemic highlighting the still weak confidence in the economy. Private sector credit by the consolidated financial system declined for a ninth straight month in the 12 months to May 2010, contracting 5%. Business credit also shrank by a significant 11%, which far exceeded the decline of 1.2% in consumer lending. The only area of credit to remain robust is real estate, which grew 6.1% in the same period. The financial system continues to experience a liquidity overhang, with commercial banks' balances at the central bank in excess of the reserve requirement recorded at around TT$2 billion in mid-July, according to the CBTT.

The build up in liquidity in the domestic financial system also resulted in sharp declines in the TT dollar (TT$) yield curve as financial institutions bid up the prices of government issued paper. In fact, the two Government of Trinidad and Tobago (GOTT) bonds which were issued this year were oversubscribed, and were issued at a premium. As a result, the TT$ GOTT yield curve has come down significantly (see figure 1). While a three-month treasury bill would have yielded an investor 7% at the end of 2008, the same tenor GOTT Treasury bill is now yielding 0.97%! The interest rate differential between the TT$ three month T-bill and the US$ three month bill has narrowed significantly, falling to a mere 81 basis points in June 2010, compared to about 690 basis points at the end of 2008.

FIGURE 1: COMPARISON OF TT$ YIELD CURVES



Source: CMMB Research Center

The CBTT is faced with a formidable challenge in that while inflation is rising, albeit due to supply shocks to food production, the economic recovery remains uncertain. This inevitably begs the question of a stagflation environment, which in simple terms is a combination of inflation and stagnation. While the policy prescription for this condition may call for a tighter monetary policy, such as increasing interest rates to rein in inflation, the Trinidad and Tobago economy is emerging from its first year of economic contraction in 16 years. What direction will domestic interest rates trend for the reminder of this year and into 2011 against this backdrop?

Given that the spike in inflation is largely a result of the supply shocks to food production and not primarily attributed to any growing domestic demand, there is a strong possibility that these pressures are temporary and should subside. The weak economy should provide enough justification for interest rates to remain low for at least the rest of this year. The government is also likely to continue deficit financing as its revenue streams stagnate both on the energy side as well as from the non-energy sectors. While TT$ interest rates are speculated to be at the bottom of the cycle now, due to the highly liquid system, there is a possibility that the medium – to long-term portion of the yield curve may come down just a bit more to reflect higher demand.

One month into the second half of 2010, there are no concrete signs of a firm global recovery, which will not help the domestic economy. While there are bits and pieces of evidence to suggest that the Trinidad and Tobago economy is rebounding, consumer confidence seems to be fragile still. Further, if global demand for energy commodities decline under a scenario of a double-dip, then any recovery by the local economy will be further delayed.

As it stands now, there are more downside risks to the domestic economic recovery. And if the rise in the inflation rate is a temporary spike, and expected to settle to more acceptable levels, then interest rates in Trinidad and Tobago are likely to remain low, with a bias to decline on the medium – to – long term portion of the yield curve, against the backdrop of the CBTT maintaining the repo rate at 5% for the rest of this year.

FINANCIAL & ECONOMIC INDICATORS

As at 29 July, 2010

Exchange Rate/US$	Closing Value	Previous Week
Yen	86.79	86.95
Euro	1.31	1.29
Jamaica	86.10	86.48
Guyana	205.20	204.20

Commodity Prices	Closing Value	Previous Week
Crude oil (US$/bbl)	78.36	79.30
Natural Gas (US$/mmbtu)	4.79	4.68
Gold (US$/Troy Ounce)	1,168.25	1,194.95

Eurobond Indices (As at 29-July-10)

JP Morgan EMBI+ (Basis points)	278
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	N/A

Policy Interest Rates (%)	Closing Value	Previous Week
United States	0.25	0.25
Euro Zone	1.00	1.00
Japan	0.10	0.10
Brazil	10.66	10.66
Trinidad	5.00	5.00
Jamaica	9.00	9.00
Barbados	2.50	2.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.14	0.15
US 10-Yr Treasury	2.98	2.94
3-month UK Libor	0.74	0.74
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	10.70	11.23
TT 90-day T-Bill	0.97	0.97
Jamaica 90-day T-Bill	8.32	8.52
Barbados 90-day T-Bill	3.26	3.26

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados,