



## Reverse Chicken Little: Pulling Back From the Slippery Inflation Slope

The inflation genie is out of his bottle and sliding down the slippery slope. Headline inflation hit double-digit 10% in October, while core inflation (a better gauge of underlying price pressures) has jumped to almost 5%. Is the sky really falling, á la Chicken Little? Is it time to panic? I don't think so. I readily admit that it will prove very difficult to bottle the inflation genie, but it is not impossible. I say this because the Central Bank has wisely made a fundamental shift in its battle against inflation, although its recent strategy has somehow not been properly communicated to the public and financial markets. The Central Bank has now decided to let the private sector finance the government's non-energy deficit through the issue of government securities, the proceeds of which will be sterilized, namely, locked away so that there is little liquidity impact. This represents an essential break with the traditional method of financing the non-energy deficit by drawing down on government balances at the Central Bank.

While fiscal operations have been in overall surplus, the government continues to run a considerable non-energy budget deficit (total spending excluding energy revenue). In FY 2007, the non-energy fiscal deficit is estimated to reach TT\$18 billion, almost the same level as in FY 2006, and sharply up from some TT\$11 billion in FY 2004. The government usually finances the deficit by drawing down on its savings at the Central Bank. This action ultimately pushes liquidity into the financial system. The classic result has been too much money – a liquidity overhang - chasing too few goods.

The Central Bank, perhaps belatedly so, has now recognized that the existing liquidity overhang is limiting the pass-through signals of increases in its policy instrument - the repo rate - to short-term interest rates. Inter-bank interest rates, for instance, continue to trade outside the operating corridor set by the Central Bank. Since March 2005, the Bank has raised the repo rate by 25 basis points each on twelve consecutive occasions to the current level of 8%. It has now decided to keep the repo rate unchanged and will focus instead on aggressive liquidity absorption.

At the heart of this strategy is the plan to issue TT\$2.5 billion in government bonds, which will help to lock away close to 15% of the resources required to finance the non-energy deficit. Given the dearth of government securities in the market, these bonds, if properly priced, will be welcome additions to the development of the local capital market. The government has already issued a prospectus for the first tranche, which is an 8-year TT\$700 million bond carrying a fixed coupon rate of 8%, to be auctioned on 28 November. There are three concerns with respect to the pricing of this bond. First, investors would favour floating rate debt to protect themselves against marked-to-market losses in a rising interest rate environment. Second, given current market expectations of high inflation over the next few years, the bond implies at least a 2% negative real rate of return. Finally, with the latest 6-month Treasury bill yielding 7.3%, it is not clear why an investor would

choose an extra 70 basis points pick up over a long duration of 7.5 years. Since these bond offerings are fundamental to a successful anti-inflation strategy, the government should allow the private sector to determine the price of financing its budgetary operations.

Apart from these bond issues, the Central Bank will also continue to step up its open market operations, having just gained sufficient room in which to play. In September 2006, Parliament raised the ceiling on open market securities from TT\$8 billion to TT\$15 billion. And, even if these open securities are exhausted, the Central Bank can always issue its own notes, as it did in 2001 during the Parliamentary stalemate. Greater sales of foreign exchange to the banking system are also contributing to mopping up excess liquidity. By the end of October 2006, the Central Bank had already sold some US\$1.1 billion in foreign exchange, which would have absorbed almost TT\$7 billion in liquidity. We should not forget the primary reserve requirement, which admittedly seems to have fallen from grace, but still remains another major policy tool in the Central Bank's arsenal to help deal with the inflation threat.

Food prices have risen by a cumulative 60% over the past three years. Flooding, labour shortages and praedial larceny are all to blame. Since the 2007 Budget, the Government has announced several measures to deal with dramatic rise in food prices, but these are yet to come together in a more comprehensive and coordinated plan with specific timelines. Among the proposed measures are:

- Creation of a Ministerial Standing Committee on Food Supply;
- Importing food – mainly perishables- from CARICOM;
- Institution of farmers' markets across the country;
- NFM to source cheaper grain supplies and NAMDEVCO to handle distribution; and
- Establishment of ten mega farms, possibly in Tucker Valley

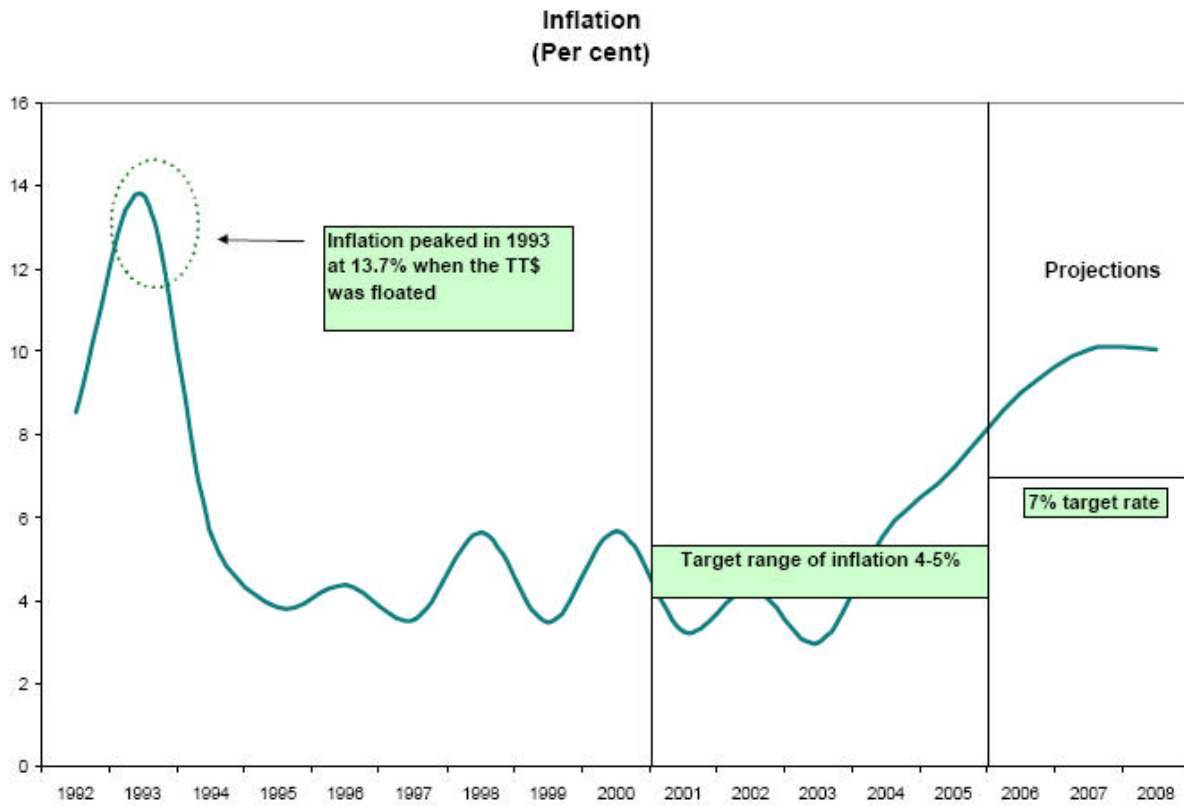
All of these measures to temper food price inflation have varying time horizons, from a few months to possibly at least a year. Setbacks can occur as with the recent flooding in the Aranguez food basket that can throw the program off-track, reigniting inflationary fears. Candid communication by both the Central Bank and the government remains critical to quelling these fears.

In the final analysis, however, fiscal restraint is all the more important to bring about a meaningful and sustained reduction in inflation. And to relieve monetary policy of an undue burden.

We have the opportunity to pull back from the slippery slope. Let's all use it wisely!

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**Figure 1: Inflation In Trinidad and Tobago**



## FINANCIAL & ECONOMIC INDICATORS

As at 23rd November 2006

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	116.30	118.21
Euro	1.29	1.28
Jamaica	66.71	66.59
Guyana	201.40	201.40

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	59.24	56.26
Natural Gas (US\$/mmbtu)	7.45	7.61
Gold (US\$/Troy Ounce)	631.25	618.25

### Eurobond Indices (Returns, % YTD as of 23- Nov- 06)

Lehman Brothers Global Aggregate Index	3.68
JP Morgan EMBI+	-18.83
CMMB Eurobond Index	3.22

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Month</u>
United States	5.25	5.25
Euro Zone	3.25	3.25
Japan	0.25	0.25
Brazil	13.75	13.75
Trinidad	8.00	8.00
Jamaica	11.95	11.95
Barbados	4.75	4.75

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	4.93	5.10
US 10-Yr Treasury	4.56	4.67
3-month UK Libor	5.23	5.23
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	13.52	13.57
TT 90-day T-Bill	6.74	6.72
Jamaica 90-day T-Bill	11.73	11.77
Barbados 90-day T-Bill	6.49	6.43

Sources: Bloomberg, CMMB Research Centre, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, [www.lehman.com](http://www.lehman.com)

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