



Can the Central Bank Put the Inflation Genie Back Into the Bottle?

The Central Bank of Trinidad & Tobago (CBTT) is carrying out a full onslaught to combat rising inflation. Unfortunately, the two main sources of inflationary pressures are outside the CBTT's span of control. And with the exception of the primary reserve requirement (which has fallen from grace) none of the policy tools in the Central Bank's arsenal can effectively deal with the inflation threat. Putting the inflation genie back into its bottle will prove to be a very difficult task.

Annual headline inflation is currently running close to 10%, sharply up from 7% in 2005 and 5.6% in 2004. Headline inflation could easily reach double digit territory in the next few months given the recent jump in inflationary expectations especially in respect of wage settlements. Two factors are mainly responsible for driving inflationary pressures - heavy government spending that is straining the absorptive capacity of the economy as well as rapid increases in food prices due to weather related shocks and higher import costs.

While fiscal operations have been in overall surplus, the government continues to run a considerable non-energy budget deficit (total spending excluding energy revenue). It finances this deficit by drawing down its savings at the Central Bank. This pushes liquidity into the system. The classic result is too much money chasing too few goods. In FY 2007, the non-energy 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.

Against this backdrop, the Central Bank has, among other things, undertaken the following actions over the past year to better manage liquidity and control inflation:

- Raised gradually (in 25 basis points increments) the repo rate to the current level of 8% from 6.25% at the start of 2006.
 - Eliminated its special deposits facility into which banks would place excess reserves at a nominal rate of interest.
 - Require commercial banks to collectively hold TT\$1.5 billion in an interest bearing deposit account at the Central Bank for at least 1 year.
 - Reintroduced the secondary reserve requirement at 2% of prescribed liabilities. Balances held as secondary reserves will be remunerated at an interest rate, which is 350 bps below the repo rate.
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Yet, these measures are unlikely to have their desired impacts. Why?

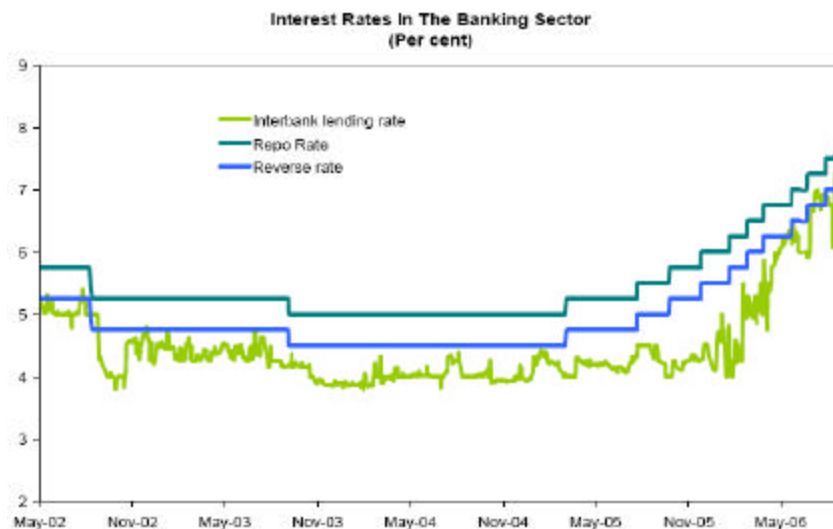
Excess liquidity is making the repo rate ineffective in transmitting desired changes in interest rates throughout the financial market. Inter-bank interest rates, for instance, continue to trade outside the operating corridor set by the Central Bank. By eliminating the special deposit facility, the CBTT expects banks to make more active use of the secondary market for managing their liquidity positions. This has not taken place. Requesting the banks to hold resources in an interest bearing account is equivalent to instituting a secondary reserve requirement; the TT\$1.5 billion translates into a secondary reserve requirement of around 5% of deposits. This brings the effective secondary reserve requirement to 7%. Many would recall that the Central Bank had used the secondary reserve requirement on prior occasions, but recognizing its ineffectiveness had eliminated this measure in October 2003 when it implemented the program to reduce the primary reserve requirement.

In addition, the Central Bank has stalled its primary reserve reduction program which sought to lower interest rates. The first phase involved a 4 percentage point reduction in the cash reserve requirement to 14% and was implemented in October 2003. The second step was a 3 percentage point reduction to 11% and took place in September 2004. The third and final phase entails a 2 percentage point reduction which, if implemented, would have brought the cash reserve requirement for banks to 9%, on par with that for non-banks. What this means is that the total reserve requirement (primary at 11% and secondary at 7%) now stands at 18% of total deposits – the same level as three years ago. And interest rates are on their merry way up.

Clearly a reprogramming of government's heavy capital spending projects would go a long way to more firmly help the inflation battle. Scaling back of expansionary fiscal policy would help take the unnecessary burden off monetary policy. Alas, the fiscal outlook suggests otherwise.

Ladies and Gentlemen, the inflation genie has left the bottle!

Figure 1: Interest Rates In Trinidad and Tobago



FINANCIAL & ECONOMIC INDICATORS

As at 19th October 2006

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	118.15	119.38
Euro	1.26	1.26
Jamaica	66.17	66.14
Guyana	201.40	200.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	58.50	57.86
Natural Gas (US\$/mmbtu)	6.08	5.17
Gold (US\$/Troy Ounce)	599.40	579.30

Eurobond Indices (Returns, % YTD as of 19- Oct- 06)

Lehman Brothers Global Aggregate Index	2.34
JP Morgan EMBI+	-23.0
CMMB Eurobond Index	1.34

<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	14.25
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	4.96	4.92
US 10-Yr Treasury	4.79	4.75
3-month UK Libor	5.13	5.11
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	13.43	13.55
TT 90-day T-Bill	6.71	6.71
Jamaica 90-day T-Bill	12.06	12.06
Barbados 90-day T-Bill	6.03	6.03

Sources: Bloomberg, CMMB Research Centre, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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