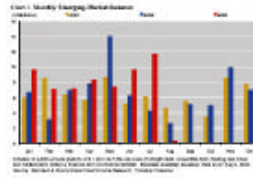




Emerging
Markets
Weekly



Vangie Bhagoo, Research Analyst

vangie.bhagoo@mycmmb.com

Should T&T Move to Inflation-Targeting?

The debate on inflation control in Trinidad and Tobago has moved to centre stage over the past few months. Headline inflation is currently running at 8% on an annualized basis, sharply up from 3-4% over the past few years. Higher government spending, monetization of the non-energy budget deficit and food price shocks mainly due to bad weather are all likely to place further pressure on prices. The authorities therefore, must devise a plan to deal with the situation before it becomes irrepressible. Many countries have adopted inflation-targeting frameworks to help bring inflation to low and stable rates, with little evidence thus far of sacrifices to growth and economic stability. Among these countries are Jamaica, Brazil, Canada, and Australia. Should Trinidad and Tobago move towards an inflation-targeting regime?

Given the difficulties in using exchange rate or some monetary aggregate as the main target, a system of inflation-targeting is quite useful as it improves transparency and accountability of the monetary authorities, which greatly improves the credibility of monetary policy. The Brazilian Central Bank has a Monetary Policy Committee (COPOM) which has the responsibility of setting the stance of monetary policy through the short term policy interest rate, the *Selic*. Under the inflation targeting system, monetary policy centers on the achievement of the inflation targets set by the National Monetary Council (CMN). If inflation breaches the target, the Governor of the Central Bank is required to write an open letter to the Minister of Finance explaining the reasons why the target was missed, as well as the measures required to bring inflation back to the target and the time periods within which these measures are expected to take effect.

The Bank of Jamaica (BOJ) also has an inflation-targeting regime, whereby the target for inflation is set by the BOJ and approved by the Ministry of Finance, and this target is incorporated in the country's Financial Program. This Program outlines and defines the main economic variables that are consistent with the inflation target. Daily monitoring of the monetary base ensures that the BOJ is able to respond to changes in economic variables in a timely manner.

The Brazilian Central Bank was able to reduce inflation from a high of over 17% in May 2003 to just under 4% in August 2006, while Jamaica contained inflation to 8.4% at the end of June 2006 from a significant 17.5% just a year earlier.

One of the options available to the Central Bank of Trinidad and Tobago (CBTT) is such an inflation-targeting regime. Currently, the CBTT has an unofficial target range for inflation of 4-5%. However, there is no structure, or governance and accountability in place. Several factors must be considered before the adoption of such a regime. Firstly, the CBTT must have a considerable degree of independence to gear its instruments of monetary policy toward some nominal goal. Additionally, the conduct of monetary policy should not be constrained by purely fiscal considerations. This means that public sector borrowing from the central bank and the banking system should be insignificant, since the government should have a broad revenue base and not dependent on seigniorage revenue. If this pre-requisite is not satisfied, large fiscal imbalances will emerge, placing pressure on prices, undermining the effectiveness of monetary policy.

Secondly, authorities should refrain from targeting the level or path of any nominal variables, such as wages or the nominal exchange rate. Under a fixed exchange rate regime or a managed peg system, monetary policy is primarily geared towards the stabilization of the foreign exchange market, rather than directly targeting any other nominal variables such as the rate of inflation. Therefore, inflation should be the undisputed paramount objective of monetary policy.

These two pre-conditions are essential for a successful inflation-targeting regime. However, the authorities will have to establish a monetary policy framework with the following important elements:

- Explicit inflation targets for some time period or periods ahead
- Clear and unambiguous indications that attaining those inflation targets is the overriding objective of monetary policy
- A model for forecasting inflation that uses relevant variables and information indicators, and
- A forward-looking operating procedure in which the setting of policy instruments depends on assessing inflationary pressures and where inflation forecasts are used as the main intermediate target of monetary policy.

Empirical evidence suggests that inflation targeting has in fact helped in reducing inflation and inflation expectations, without raising output volatility. There was also significant improvement in the ability to predict inflation, in addition to contributions to price stability, preventing one-time shocks to inflation from affecting inflation permanently.

Thus, inflation-targeting can be considered as one of the viable options for the CBTT in controlling the current inflationary situation in Trinidad and Tobago.

FINANCIAL & ECONOMIC INDICATORS

As at 31st August 2006

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	117.40	116.54
Euro	1.28	1.28
Jamaica	65.96	66.08
Guyana	200.70	200.70

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	70.26	72.36
Natural Gas (US\$/mmbtu)	5.84	7.22
Gold (US\$/Troy Ounce)	627.30	621.24

Eurobond Indices (Returns, % YTD as of 31-August-06)

Lehman Brothers Global Aggregate Index	1.96
JP Morgan EMBI+	-18.82
CMMB Eurobond Index	-4.74

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Month</u>
United States	5.25	5.25
Euro Zone	3.00	3.00
Japan	0.25	0.25
Brazil	14.25	14.75
Trinidad	7.75	7.50
Jamaica	12.15	12.45
Barbados	4.75	4.75

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	4.91	4.96
US 10-Yr Treasury	4.73	4.81
3-month UK Libor	4.98	4.97
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	14.03	14.30
TT 90-day T-Bill	6.42	6.24
Jamaica 90-day T-Bill	12.29	12.29
Barbados 90-day T-Bill	5.20	5.20

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

DISCLAIMER

The information contained in this documentation is for your information only. All information contained in this documentation has been obtained from and is based on sources, including but not limited to, newspaper and magazine articles that CMMB believes to be accurate and reliable. However such information, facts, calculations, methodology, assumptions and estimates contained in this documentation have not been verified by us. All opinions and estimates constitute the Author's judgment as of the date of the documentation which are subject to change; however neither its accuracy and completeness nor the opinions based thereon are guaranteed. As such, no warranty, express or implied, as to the accuracy, timeliness or completeness of this documentation is given or made by CMMB in any form whatsoever. Consequently, CMMB assumes no liability for the accompanying information, which is being provided to you solely for general information.