

Money Matters

With compliments from CMMB

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OUTLOOK

for interest rates in T&T

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In Trinidad & Tobago there is a lack of consensus on where interest rates are going in the long term. In trying to make a prediction about where rates are going, most analysts use a combination of quantitative as well as qualitative analytical methods.

Trendology

There is a popular quantitative method, using regression analysis, called "Trendology". Without going into any heavy statistical methodology, using the least squares principle and regression lines, suffice it to say that it is possible to come up with an equation which provides a trend line from which we can "predict" what future Prime rates would look like over the next few years.

Based on this methodology, we have calculated that as at 1 November, 2004,

if the trend continued, Commercial Prime would be 16.64%. At 1 November, 2008, it would be 17.69%. However, Prime today is at 9.5% due to a programme of reserve reductions initiated by the Central Bank.

Reduction of statutory reserve

Just recently, the statutory reserve requirement for commercial banks was reduced from 18% to 14%, releasing \$640 million into the financial system. These funds were immediately sterilised

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by the Central Bank via the issue of Government Bonds.

Currently, the Central Bank's monetary policy agenda is to sustain a low interest rate environment to stimulate the economy.

While there was no expansion in money supply because the intermediation costs of banks have been reduced, commercial banks have instituted a reduction in their Prime lending rate, passing on the savings in intermediation costs

to their borrowers. Intermediation costs arise because for every dollar deposited into the bank, it can lend only 86 cents (previously it was 82 cents before the recent Central Bank intervention).

Government's fiscal policy is decidedly expansionary as evidenced by the pattern of spending over the past three years.

It is expected that the Prime rate would continue to fall over the next eighteen months as the Central Bank has indicated that it hopes to reduce

the reserve requirement for banks down to 9% in order to "level the playing field" between the banks and the non-bank financial institutions.

Only 8% of this year's budget is on developmental expenditure, the other 92% being used for recurrent expenditure.

By April 2005, approximately another TT\$800 million would be released into the financial system, although it would more than likely be sterilised in the form of another Government Bond issue.

Thus we expect that further reductions in the intermediation costs of commercial banks would result in their Prime lending rates coming down by

another 2.5% to settle at around 7%. It seems, therefore, that the Prime rate would have come full circle to the 1971 level of 7.5%.

The reductions in the reserve requirement and Commercial Prime represent a reversal of the trend we have witnessed over the past few years. Quite clearly, there is a shift in monetary policy by the Central Bank.

More importantly, however, the Central Bank is now better equipped to monitor and control the financial system through the use of monetary instruments that are more exacting in terms of their effect on the money supply.

Sharp spikes due to blunt instruments

The availability of monetary policy instruments in formulating an outlook on interest rates cannot be overemphasised. If one examines the history of the money market over the past 10 years, the interest rate environment has been extremely volatile, and there would have been very sharp spikes in interest rates due to the very blunt instruments of monetary policy employed in the early 1990s.

In fact, the reserve requirement was the primary method of effecting the Central Bank's monetary policy agenda. This created significant liquidity shocks to the environment. Later on, with the advent of Open Market Operations in 1998, the intention was to remove the shocks, which arose from changing the reserve requirement.

We have come a long way in the evolution of the monetary landscape. Currently, the Central Bank's monetary policy agenda is to sustain a low interest rate environment to stimulate the economy, and they now have the instruments with which to carry it out.

Overnight Repo Facility

Apart from Open Market Operations as a tool, the Central Bank has also recently put in place an overnight repo facility that banks can utilise to manage their liquidity. This is another very significant addition to the range of instruments available to the regulators and, if operated in the right manner, would ensure that the violent shifts in liquidity witnessed during the 1990s would not recur.

All things remaining constant, the monetary environment over the next year or so should facilitate the Prime Lending Rate falling, while the rate on Treasury Bills should remain flat or fall slightly.

The Fiscal Side

On the fiscal side the situation is less clear-cut. Government's fiscal policy is decidedly expansionary as evidenced by the pattern of spending over the past three years. In fact only 8% of this year's budget is on developmental expenditure, the other 92% being used for recurrent expenditure. The Budget this year is a staggering \$22 billion, out of which \$20.2 billion is for recurrent expenditure. Of the \$22 billion, the borrowing requirement is \$3 billion; \$2 billion to be raised overseas and \$1 billion locally.

The Budget was predicated on a price range of US\$23 - US\$25 for the various crude oil blends produced locally. However, this year the IMF has stated there is a one sixth chance of the price of oil falling by US\$2/bbl.

The oil price sensitivity of this country a few years ago was approximately US\$100 million in lost revenues for every US\$1 drop in the price of oil. But now, because the economy has diversified away from oil into gas, the sensitivity, on a conservative basis, would be about US\$60 million in lost revenue.

If the price of West Texas Intermediate falls by US\$2/bbl, the borrowing requirement would increase by US\$120 million or TT\$800 million, which would have to be funded from the local market.

Worst Case Scenario

In a "worst case" scenario, the Government may have to borrow about TT\$1.8 billion domestically. Given that liquidity in the financial system is currently around \$1 billion, it means that the Central Bank would have to release another TT\$800 million for this year to be able to fund the "worst case" borrowing requirement. And this can easily be funded from the programme of reserve reductions that the Central Bank has embarked upon.

Even if oil prices were to fall by US\$2 per barrel, the larger local financing requirement can still be raised from the excess liquidity in the financial system coupled with any reserves the Central Bank may release. And this can be achieved without any upward pressure being placed on interest rates.

However, judging from the trend in borrowing over the past three years, we can assume that the same situation would persist in the future. In 2002, the Government borrowed TT\$1.5 billion, in 2003, \$2.25 billion and this year it is projected that the borrowing would be \$1.8 billion domestically.


However, by the end of this financial year, if the reserve is reduced to 9%, it is doubtful that the Central Bank would be able to release future reserves given that the reserve requirements across the Caribbean are around the 9% level. Besides, the reserve requirement, for all intents and purposes, should not be reduced to an imprudently low level, since it is not strictly speaking an instrument of monetary policy, but rather a virtual emergency fund in case

of a run on the financial system. Assuming the Central Bank would not be able to release funds below the 9% level, it means that Government's borrowing requirement can only be funded from the money supply in the system rather than Central Bank reserves.

Interest rates could increase

Based on this analysis, the possibility therefore exists that from 2005 onward, once the Government's programme of deficit financing continues, there is a distinct possibility that interest rates could increase. However, if the Central Bank institutes countervailing measures to even off any tightening, the low interest rate environment could be sustained. In our opinion the newly instituted "repo" facility at the Central Bank is the unknown factor in the equation. If it is allowed to function properly, banks can "repo" their Treasury Bill holdings with the Central Bank to expand their liquidity levels when necessary. Let us hope that this would be the case, as most of the recently issued Government Bonds have been carrying yields in the 5-6% range; which are historic lows for Government debt when compared to the 11-12% levels witnessed just three years ago.

Outlook

Thus, the outlook for short-term interest rates is flat even though Prime could possibly come down by another 2.5%. In the medium to long-term, fiscal policy and Government borrowing could create some pressure on money supply. However, if the Central bank's "repo" facility can be effectively mobilised to neutralise this effect, then low rates would become sustainable. If not, some spikes are possible though not to the extent witnessed in the latter part of the 1990s. 

Well hello there, my friends, is D' Promenade Investor here, recuperating from another hectic Christmas season here in T & T. By the time you read these words, the presents will all have been opened; Christmas carols and parang replaced by the pulsating sound of Calypso; and all that remains of the ham, turkey and pastelles is that irritating bulge over your belt buckle. And worst of all your next salary isn't until late January and your credit card payment is due in ten days.



“Santa, I spent all the money, you have some spare cash???”

YOU KICK YOURSELF and wonder how you ever got into this financial mess.

Well it's too late to cry over spilt milk as they say. You just have to make sure that this is the last time that this happens to you. Here are a few tips to avoid the financial pitfalls that the Christmas season presents to the unwary.

DON'T leave the Christmas shopping till December.

Invariably everyone waits till November or December to buy those gifts for those special persons in our lives. This is a time of year when every store's mission is to relieve you of as much of your hard-earned cash as possible. Purchase gifts during the year when you can take advantage of sale prices and tuck them away in a safe place until its time to wrap them and place them under the tree. This also spreads the cost over a longer period of time and the impact isn't going to be as distressing.

DO start a Christmas Fund or join a Christmas club.

Save a small sum every month from January to November either in a designated bank account, Money Market Account or Credit Union, even a Sou Sou. Then when the Christmas season approaches you can use that money to do your gift shopping, stock the refrigerator and the bar and pay for the Old Year's Night party.

DON'T max out your credit card.

While the extended credit period is a nice feature, if you run your credit card up to its limit, its going to be all the more difficult to clear the entire balance at the next payment date. This will result in interest and finance charges being added to your account and will push you further into debt. And remember Carnival is just around the corner; another period of high expenditures so do exercise restraint to avoid this trap. If you're an impulse shopper like me, try leaving the cards at home until you're ready to make that purchase, or freeze it in a block of ice so it won't be immediately available. Whatever you do be sure to use credit wisely.

DO choose gifts wisely.

It's easy to get caught up in the advertisements and the hype and purchase the latest gadget or that toy robot that your child will just LOVE, at least until New Year's Day.

Consider giving gifts that will be a little easier on your wallet and won't require batteries every four hours of use. Give a gift of a good book or a magazine subscription or possibly open an investment account for that loved one. I'm sure with a little thought you can find that perfect gift without having to take a second mortgage on the house.

DO use those discount coupons, bonus points or Magna rewards instead of cash when doing your shopping.

Save them up during the year and then you can put them to good use to ease the pressure on your resources at Christmas. Also remember to shop around before you buy. Who knows, that perfect outfit might be on sale at the next store you visit and you could save a bundle. Scan the papers and listen to the radio for hints on where to find those bargains.

Some Christmas...



DO's and DON'Ts

DO consider investing part of your December salary payment in a 30-day fixed income instrument like a fixed deposit.

This way you not only will have the cash available when you need it in January but you will have earned some interest on it as well. Remember a penny saved is a penny earned.

DO spend time with your family and loved ones.

Like the song says the true spirit of Christmas isn't in the gifts you give but the Christmas things you do all year through. Consider taking the time to visit friends and relatives that you haven't seen during the year instead of an expensive dinner or that all-inclusive event. It's all about the quality of time spent and not necessarily the quantity of money spent that matters.

DO remember not to overindulge.

All too often during the Christmas season we get carried away with the festivities and overeat and drink. The annual carnage on our nation's roads is a grisly testament to that fact.

Try to avoid taking that one drink too many, who knows, the life you save may be your own or that of a loved one. In all things let moderation be your guide.

DO take the time to read the fine print in those sales contracts; especially those that offer extended payment terms.

All too often there are high interest rates attached or penalties if you don't make payments on time, or there is a large lump sum payable later on.

Also, concentrate on satisfying your needs not necessarily your wants. Maybe you don't really need that 500-piece tool kit guaranteed to work on every nut or bolt known to man. Remember if something sounds too good to be true, it probably is.

Last but not least: DON'T lose sight of your financial goals.

Whether it's owning your own home, university tuition for your kids or financial freedom for you and your family, these are much more important than the temporary euphoria from the normal excesses of the Christmas season. Don't let all your hard

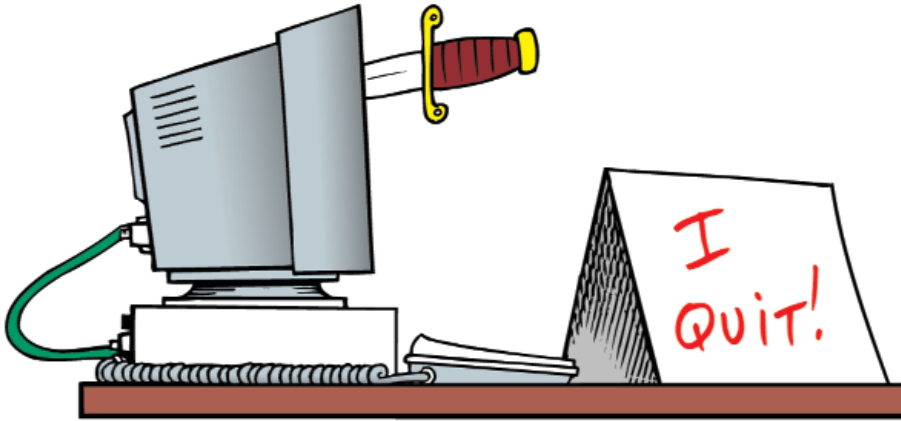
work during the year be wiped out by a couple of days of fete and merriment. Remember the sacrifices you have made in the past and keep your focus.

Well, time for me to get off my soapbox and start working on my New Year's resolutions. Hope I didn't sound like the Grinch but I do have your best interest at heart. Till next time, this is the Promenade Investor wishing you and your loved ones a safe holiday season and a bright and prosperous 2004.

**Happy Investing!!!
D' Promenade Investor.**



Losing your job without losing... ...YOUR MIND!



LIKE IT OR NOT, job loss is something we all should be prepared for. If we suddenly become unemployed, the situation would not be as stressful if we spent some time now on planning our finances. In this way we'll be better able to avoid sinking into the trap of unmanageable debt caused by job loss. Also, we wouldn't have to accept those unpleasant jobs that we will end up hating. To prevent such a terrifying situation in the future, take a few minutes now to do the following:

Establish your current financial position.

The first most obvious place to start is with your current financial position. This is where you establish what all your assets and debts really are and not what you want them to be. Many people are afraid of what they will find if they do this but go brave - ignorance is not bliss! Exploring your existing financial state, as satisfying or disappointing as it may be, will give a realistic view of where you are now and how much added work you have to put in to get where you want to be.


Get a feel for your job stability. How are your employer's competitors doing? Are they experiencing lay-offs? Can either man or machine easily replace you or your job? Are your skills in demand? How is the economy performing? These questions can give good

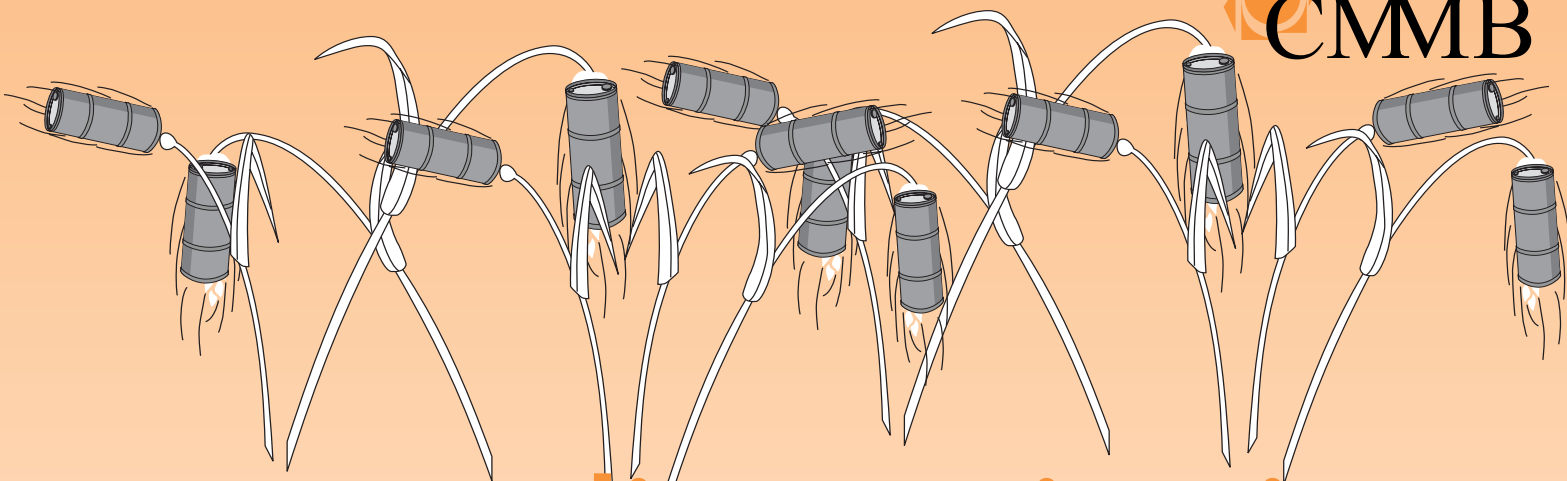
clues of what might occur and if it will affect you and the job you perform. If job lay-offs are occurring in your company, that is usually a strong sign that you should be updating your resume and start looking out for any opportunities that you can take advantage of.

Know your employer's job severance policy and other benefits: Now we come to the employer. If your company is currently laying off employees, are the workers entitled to severance pay? What basis is used to determine how much an employee should receive, e.g. years of service? You must find out about all the areas where it will be possible for you to gain the extra dollars. Familiarise yourself with your employer's severance policy now. By being informed of extra income you are entitled to, it will help you to better calculate how much money you need in your emergency living expenses fund.

Establish an emergency fund: We've all heard that the only constant in life is change, and as the situations we are placed in on a daily basis changes, the need to establish an emergency fund is becoming increasingly important. An emergency fund should be established by all and not just by those with little job security. Without such a fund you might end up incurring a lot more unexpected

debt, which is usually the most expensive debt, that can keep you down for a longer period. The amount of money that should be placed in the fund will be determined by your basic living expenses and whether or not you have dependents. The more people you support the more likely you will have unplanned expenditure and the more you should therefore keep in the fund. A budget is also very useful at this point. It will show you what your expenditures and incomes are and it will point out what your basic necessities are and what is the minimum amount you need. This step will help you determine if the emergency fund should equal to three, six, twelve months of your expenses. These funds should be placed in a liquid investment such as a money market account, savings account or chequing account, where you can have access to it on short notice.

If it actually happens: Job loss will be easier to deal with financially and emotionally if you've prepared for the worst. If the dreaded moment occurs, here are some additional tips for getting through the period of joblessness: If you're entitled to severance pay, use it sensibly. Make the money last as long as possible and use it as a bridge to get you through the rough times. This means that the money should only be spent on your most pressing needs such as rent, mortgage, groceries etc. Limit the use of credit cards, as tempting as it may be, resist the urge to splurge beyond your means. Leave the card for absolutely necessary cases. Contact your creditors and explain your jobless position and try to renegotiate a reduced payment until you gain employment. Finally, try and get back into the game as soon as possible. This means taking the updated resume you prepared earlier and start sending them out to potential employers. Never wait a long time before you start looking for a new job. The longer you wait the lower your chances of gaining employment as your skills will become outdated or your future potential employer will be skeptical of hiring someone who has not worked for some time. 



Commodity Derivatives: Immunising the economy from oil price volatility

TRINIDAD & TOBAGO is endowed with rich natural resources of oil and gas. Yet every year for the past two years, despite projections of increased revenues, our public debt has been increasing. Last year the Government borrowed TT\$2.2 billion to finance its budget and this year another TT\$3 billion is projected. It seems that the more money we are projecting to derive from LNG the more we are spending today. Also, the higher the level of oil price projected the higher is the size of the budget deficit. This pattern of expenditure is not sustainable and is a worrying trend when the experience of other resource-rich nations is examined.

The Dutch Disease

Historically, resource-rich developing countries have fallen victim to the Dutch disease. This refers to the paradoxical phenomenon, whereby economies highly endowed with natural resources grow at a slower pace than those not as endowed. The situation with oil-rich nations is no different. Transitory oil prices have led to increased spending, often maintained even after oil revenues had fallen again. This combination of oil price volatility and procyclical

macroeconomic policy has resulted in an irretrievable boom-bust cycle and economic underdevelopment. For example, despite Venezuela's estimated US\$600 billion in oil exports since the early 1970s, real per capita income fell by 15% between 1973 and 1985. The situation was made even worse in the 1985-2000 period with GDP per capita falling on average by 2.2%. Similarly in the case of Nigeria between 1999 and 2001 as oil receipts rose from US\$7.78 billion to US\$15.3 billion, consolidated Government spending increased from US\$12.2 billion to US\$21.7 billion. This pattern of expenditure has led to spiraling budget deficits and heavy debt loads leading to economic stagnation in these potentially rich nations.

The source of this problem is the inherent volatility of oil prices, which has to do with its many dependencies. Over a period of just a few years the sharp shifts in oil prices has been glaringly evident. Oil plunged to US\$12/bbl in 1998 to spike back up to US\$20/bbl in early 2002. The IMF has also stated that in 2003 there is a one in six chance of the price of oil falling by US\$2/bbl. There is also the risk of Iraq supply coming on stream in 2004, thereby

depressing the long-term average price of oil even further.

What is the state's economic philosophy?

Whether the price of oil goes up or down is not the issue. The relevant question that has to be asked is "what is the economic philosophy of the state?" There is an argument gaining support that the state should not be in the business of taking oil price risk exposure. Rather, the prescription is to immunise revenue streams from the vagaries of the international price environment. A number of oil-rich nations are adopting this approach having regard to the mistakes of history. It is not only an economic imperative, but is also politically expedient to governments.

Revenue Stabilisation Fund

There have been a number of mechanisms proposed in order to smooth revenue volatility. The most popular of these is the Revenue Stabilisation Fund in its many forms. However, there is a misconception about these funds since they were originally developed to solve the problem of intergenerational equity, and not to hedge oil price volatility. Putting aside money from non-renewable resources for the

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benefit of future generations does not hedge the risk of oil prices. This is because there is no well-defined time-invariant mean reverting tendency observed in oil prices, and so a system of fund allocation based on these rules would crumble in the face of shocks which are often large and long-lasting. Therefore, to say that these funds provide a hedge to revenue reduction is to harbour a serious misconception.


Solution: Commodity Derivatives

There are ways by which oil price exposure can be sold off in the financial markets. This can be accomplished by the use of commodity derivatives, the return distributions of which can be combined with existing revenue streams to provide a constant synthetic revenue flow. There are many variants of these derivatives, which can be customised to the

specific dynamics of a particular country. Surprisingly, some of the more progressive nations have already gone onto the international financial markets to accomplish this. For example, in the late 1990s and during the first half of 1991, Mexico used financial risk management tools to protect its earnings from volatility. The transaction was constructed so that the Mexico would effectively lock in a price of US\$17/bbl. When the results of the hedge were considered, the savings derived were quite significant. A senior Mexican official was quoted as saying, "We said listen, given the uncertainty and given the volatility, it can go to US\$40/bbl or it can drop to US\$10/bbl. We have a budget here, a budget that we have to cover [...] We didn't do it to be ahead. The Government does not speculate in that sense. Doing nothing is speculative. It does look good

now that we are ahead compared to doing nothing. Some days we do not do as well. But we sleep well."

Can T&T go to the international markets?

There is no reason why Trinidad & Tobago should not be going to the international markets to hedge oil price risk exposure. Some analysts have indicated that our country loses US\$70 million or TT\$420 million for every US\$1 fall in the price of oil. If the price of oil falls by US\$2, the country's borrowing requirement would therefore increase by TT\$840 million. Our debt load is now approximately 67% of Gross Domestic Product above the international EU benchmark of 60%. The only way to arrest this increasing debt load is to reduce the volatility of our revenue streams. 

SEASON'S GREETINGS FROM THE CMMB FAMILY

*Your loyalty and efforts are
The foundation our success is built on.
May your Holidays and New Year
Be filled with happiness.*

