Republic Economic NEWSLETTER

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The Story of Recent Developments:

CHANGE HAPPENS

Overview

From the performance of an athlete, to weather related damage, to international developments, change seems to occur suddenly; like a bolt out of the blue. More often than not though, the factors that brought about the change were evolving incrementally but steadily, and were either missed by the casual observer, ignored by others or discounted by the hopeful.

By most accounts economic activity was healthy in the third quarter, but coming after what appears to be a strong second quarter performance, Republic Bank estimates that growth in the third quarter was just 0.2 percent when compared to the second quarter. The third quarter saw a number of changes, from the domestic benchmark interest rate, to international oil prices. Energy sector indicators were a mixed bag, while the non-energy sector is believed to have been buoyed, with strong activity in the construction and distribution subsectors continuing on from the second quarter. Average prices were 1.7 percent higher in the third quarter than the second, and the unemployment rate was estimated to have remained steady at the first quarter figure of 3.2 percent.

Trinidad and Tobago
Key Economic Indicators

Indicator	2013	2013.3	2014.3 p/e
Real GDP (% change)	1.7	0.3	0.2
Retail Prices (% change)	5.2	-2	1.7
Unemployment Rate (%)	3.7	3.7	3.2
Fiscal Surplus/ Deficit ($M)	-4,175.2	-3,396.60	-6,844.1
Bank Deposits (% change)	12.4	4.6	0.4
Private Sector Bank Credit (% change)	3.7	1.3	1.3
Net Foreign Reserves (US$M)	12,329.2	11,782.7	NA
Exchange Rate (TT$/US$)	6.39 / 6.44	6.39 / 6.44	6.33/ 6.37
Stock Market Comp. Price Index	1,185.10	1,143.60	1,145.12
Oil Price (WTI) (US$ per barrel)	97.91	105.84	97.78
Gas Price (Henry Hub) (US$ per mmbtu)	3.73	3.55	3.96

Source: Central Bank of Trinidad and Tobago, TTSE, EIA
p - Provisional data
e - Republic Bank Limited estimate

Energy Sector

The ‘Review of the Economy’, released with the presentation of this country’s national budget in September, estimates energy sector growth of 1 percent for 2014 (down from 1.6 percent in 2013), and attributes it to expansion in sub-sectors such as exploration and production, service contractors and distribution. It remains to be seen if things will go as expected, as conditions have changed appreciably in recent months.

The third quarter itself saw a mix of positive and negative developments. Average oil production increased by 3.3 percent to 82,594 barrels per day (b/d) and natural gas production grew by 4 percent to 4,115.6 million standard cubic feet per day (mmscf/d). While average monthly ammonia and methanol output fell by 2.4 percent and 5.4 percent respectively, average monthly LNG production surged by 13.1 percent to 2,800,528 m3 (cubic metres). The exploration indicators were less than impressive, with rig days falling from 753 in quarter two to 576 in quarter three, and depth drilled registering a marginal increase of 1.2 percent, to 94,792 feet over the same period. It is however, developments in energy prices that have garnered the most attention in recent months. While average crude oil prices (West Texas Intermediate –WTI) fell by 5.4 percent in the third quarter to US$ 97.78 per barrel and natural gas prices dropped by 14.1 percent to US$3.96 per mmbtu, the pattern of oil price movement in the second half of this year, has become either ominous or encouraging, depending on your (country’s) level of energy dependence/independence. This pattern has seen average crude oil prices decline steadily from US$105.79 in July to approximately US$75.65 in November (Chart 1)

With the extremely important role that oil plays in this country’s economy, government ministers have been at pains to assuage the concerns of a population anxious about the impact of these developments on the economy and revenue inflows. The fact is, there are no simple answers to the concerns expressed, because oil price changes bring both gains and losses. While most people will appreciate that the government benefits from lower oil prices through a smaller fuel subsidy bill, far fewer are aware that the state oil company Petrotrin, through its refinery operations, benefits in some ways as

Chart 1: Crude oil prices (WTI) - 2014

Sources: Energy Information Administration   *Date to November 24th

well. Trinidad and Tobago has been a net oil importer for years, buying much more crude oil than it sells. During the first nine months of this year, the country exported 8,781,632 barrels of oil and imported 15,372,415 barrels; 8,556,476 barrels of which (55.6 percent) came from the Central African nation of Gabon. This dominance is set to change though, as reports indicate that concerns over the Ebola virus prompted this country to substitute crude from Gabon with shipments from Colombia and Russia. It is also worth remembering that while natural gas prices are likely to trend downward, the US price used as a benchmark by this country is not the best reference price, as most of T&T's gas (in the form of LNG) is sold in the higher priced markets of South America, Europe and Asia. Little has been made known about these gas trades and their relation to revenue inflows.

Non-energy Sector

The non-energy sector was estimated to grow by 2.5 percent in 2014, with an anticipated contraction in the manufacturing sector (-0.7 percent) being offset by moderate performance in agriculture (0.8 percent) and a solid 3 percent expansion in the services sector. The services sector growth projection was facilitated by expected expansions in the finance, insurance and real estate (5.5 percent) and construction and quarrying sub-sectors (7.1 percent). In the absence of data for the third quarter, anecdotal evidence suggests that at least one of these projections have played out. Local cement sales for the period October 2013 to June 2014 totaled 500,000 tonnes, a 9.7 percent increase over the 455,900 tonnes for the same period a year earlier. While quarterly statistics are only available to March this year, calculations indicate that local cement sales for April to June were a whopping 194,900 tonnes. While this is a significant change from recent sales figures, we are confident that this momentum carried through to the third quarter.

Fiscal Policy

Reports from the Ministry of Finance and the Economy indicate that government recorded an overall deficit of $4,876.6 million for the just concluded 2013/2014 fiscal year. While no data has been published for the fourth quarter of the fiscal year, based on the figures for the first three quarters, we can conclude that an overall deficit of approximately $6,844 million was incurred for the July – September period. With respect to the overall deficit of $4, 876.6 million, $1,608.9 million was projected to be sourced domestically and $3,267.7 million externally.

Debt

Total Public Sector Debt or Gross Public Sector Debt at the end of September 2014 was projected at $101,994 million or 56.7 percent of GDP. If Open Market Operations (OMOs) such as Treasury Bills, Treasury Notes and Treasury Bonds are excluded, the new figure, known as Net Public Sector Debt, is $78,134.7 million, equivalent to 43.4 percent of GDP.

Monetary Policy

After being maintained at 2.75 percent since September 2012, the 'Repo' rate was changed on September 26, 2014 to 3.00 percent. The decision by the Central Bank's Monetary Policy Committee was prompted by the following developments.

i) *Domestic inflationary pressures* - The trend of relatively sedate prices that saw year-on-year inflation average just 3.4 percent for the first six months of the year, changed in the third quarter. Inflation registered 5.9 percent in July before a sharp increase in food prices pushed the rate to 7.4 percent in August and 7.8 percent in September. Expected increases in public spending in an already highly liquid environment are likely to add to inflationary pressures.

ii)*Increased attractiveness of US investments* – Yields on US Treasury securities increased in anticipation of a rise in the US benchmark rate by mid-2015.

iii)*Evidence of growing non-energy sector demand* – Strong sales of cement and new cars are indicative of growing strength and reduce the need for accommodative monetary policy.

Commercial bank deposits grew by just 0.4 percent in the third quarter, marginally down from the 0.5 percent of quarter two. Private sector credit increased by 1.3 percent over the quarter to $24,390.9 million, an increase of 3.8 percent over the September 2013 balance. Consumer loans grew by 2.6 percent in the quarter and by 8.9 percent year-on-year.

The downward trend of the local stock market in 2014 continued through the third quarter, with the Composite Price Index of 1,145.1 at the end of September, 1.8 percent lower than the June figure. While Trinidad and Tobago's reserves position remains healthy, latest available data shows a steady decline over the last two months to US$12,401.2 million in August.

Outlook

Due to the shielding effect of the fuel subsidy, the non-energy sector will not enjoy any fuel cost savings as a result of current low oil prices. If the lower prices persist over the next six months however, some businesses may realize savings in the form of lower import costs for oil-based products like lubricants and material inputs with plastic components, such as electrical fittings and wiring. The construction sector should continue to be buoyant and activity is likely to even intensify as government continues its infrastructure drive through the upcoming dry season, with a major new project added to the mix, in the form of the reconstruction of the Manzanilla – Mayaro road.

The impact on the energy sector going forward is somewhat less clear. Republic Bank's Economic Intelligence Unit believes that crude oil prices could stay within the US$65-US$80 range over the next six months. While there is sure to be concern, energy sector activity is likely to remain largely unchanged during this short forecast period. Developments with negotiations for downstream projects may be a different matter.

As an energy based economy in which oil has played and still plays a major role, it is unlikely that protracted lower oil prices will not have an overall negative effect on this country's revenue. For reasons given above, the size of the negative effect is difficult to quantify. One good thing coming out of the recent phenomenon of lower oil prices, is that the Minister of Energy and Energy Affairs has committed to getting a clearer idea of the relationships between oil exports, gas exports and government revenue, and bringing this information to his cabinet colleagues. It would be great if a detailed analysis of these important relationships could be carried out and the information be made available to the national community.

THE MODEL IS BROKEN

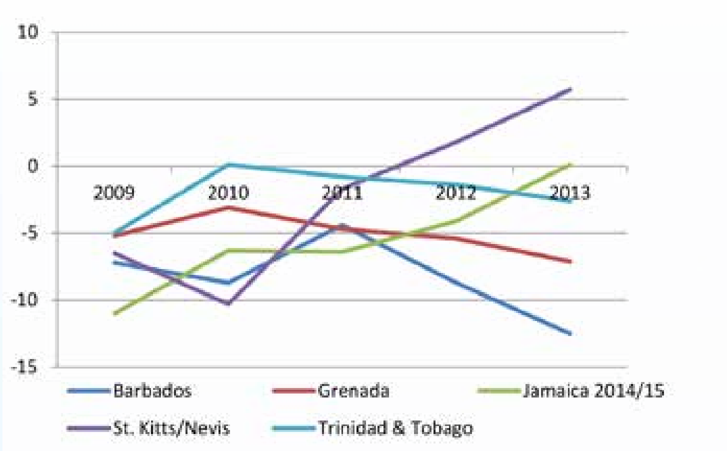
Adapted from a speech delivered by Mr. Ronald Harford, Chairman of the Board of Directors, Republic Bank Limited

In the year 2014, the economies of the OECS and the wider Caribbean, stand with their backs against the wall, thrust into that position by behemoth forces. To be specific, the region's development to this point has been hamstrung by an unsustainable economic model and the uncompetitive nature of its key sector, tourism. The main cause of the region's struggles is not the global financial crisis, which started in 2007, although it has stifled the flow of capital to the region. Neither is it the resultant global economic recession, which we could all attest, constrained demand for tourism and Caribbean exports. These events merely exposed the region's Achilles' heel, namely the broken model on which the economy is based.

One of the greatest shortcomings of the Caribbean's political system is that it allows successive administrations to focus too much attention and resources on appeasing the electorate, at the expense of activities that are beneficial to the future common good. Equally damaging, is the low level of accountability of our leaders, who are permitted to avoid hard questions such as those related to corruption, expenditure and unrealized budget plans. The sad reality is that our political structure in some ways impedes the region's long-term development.

Fiscal management in the Caribbean is severely deficient. Many governments run perennial deficits (Figure 1) and create debt, the proceeds of which go to unproductive uses. These unproductive uses have neither consistent nor self sustaining sources of revenue to repay debt. Governments therefore tend to fill revenue shortfalls with deficit financing and lengthy delays in paying for goods and services. This is basically servicing debt with more debt, a perfect recipe to allow debt to accumulate to unsustainable levels.

Figure 1: Fiscal Balance (% of GDP)



Sources: Central Bank of Barbados, Central Bank of Trinidad & Tobago & International Monetary Fund

For years, buoyant economic activity masked the true effects of the profligate fiscal policies adopted by many regional governments. During this period, the state used the funds from deficit financing to employ an ever increasing proportion of the labour force and directed scandalous amounts of public resources to unproductive means in the form of transfers and subsidies. For political reasons, governments establish these expenditure patterns and they become entrenched. For instance, St. Lucia's 2014 Budget allocated 74 percent of expenditure to recurrent spending and was based on a fiscal deficit of 5.7 percent of GDP; 94 percent of Trinidad and Tobago's 2015 budget was dedicated to recurrent expenditure, with a deficit of 2.3 percent of GDP. In December 2013, the IMF indicated that Barbados had the highest relative wage bill in the Caribbean, equivalent to 10 percent of GDP. Its fiscal deficit reached an estimated 12.5 percent of GDP in the 2013/2014 fiscal year. The country's wage bill consumed 39 percent of recurrent revenue in the 2013/2014 fiscal year, compared to 33 percent for St. Kitts & Nevis, 41 percent for Jamaica and 16 percent for Trinidad & Tobago (Figure 2). Grenada's wage bill is expected to reach 52 percent of recurrent revenue in 2014. During the same period, Barbados' current expenditure was 141 percent of current revenue while, the ratio was above 92 percent for both Jamaica and Trinidad and Tobago. Grenada's current expenditure was 106 percent of revenue (Figure 3).

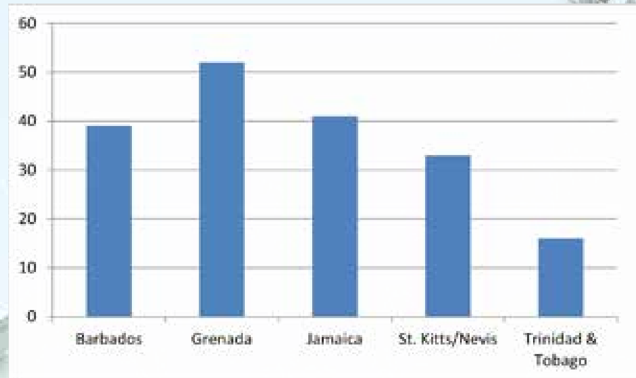
This pattern of spending serves to crowd out the private sector and thus, impedes the dynamism of the economy. Worse still, it leaves the affected countries with onerous debt and fiscal balances for generations to come. Consequently, Antigua & Barbuda, Grenada, St. Kitts & Nevis, Barbados and Jamaica all have debt levels close to or above 100 percent of GDP (Figure 4), while several regional governments are now confronted by double-digit or high single-digit fiscal deficits. The deterioration of public accounts to such an extent undermines growth, as countries now have to direct significant resources to repay debt. According to the Eastern Caribbean Central Bank, debt service payments averaged 22 percent of revenue in the OECS in 2013 (financed largely by deficits as pointed out before.)

The regional financial sector has a long history of funding government's fiscal deficit and buying public debt. Insurance companies by law are mandated to purchase government debt to cover long-term liabilities. Banks and insurance companies are now financing sovereigns with 100 percent to 200 percent debt to GDP. This debt is of course, unsecured. The opportunity costs of holding government debt can be significant for banks, since they may be able to generate greater rates of returns in an open currency market by investing in gilt-edged securities or lending to the private sector. Of even greater concern, are losses incurred when governments default on debt payments or require banks to take "haircuts" on outstanding debt because of insolvency. This jeopardizes the long-term and short-term savings of the population. It is one thing to have a defaulting Sovereign, but it is a catastrophic event when this is coupled with financial institutions' default. At the moment, Grenada is trying to convince private sector creditors to forego repayment of a portion of debt, already issued to the government. Anemic economic conditions and high exposure to public sector debt, has undermined the financial sector's profitability and depleted its capital base in the OECS.

For some time now the Region has had to make do without grants and aid. It is time that the Caribbean put the days of deficit financing behind it. Going forward, rigid budget controls will cause the money supply to contract. The consequence for the OECS then, is a severely overbanked region. Scotiabank recently announced plans to close 35 of its Caribbean branches and retrench 1,500 employees. This follows similar restructuring activities by the Royal Bank of Canada earlier this year. The 1970s saw the exodus of the American Banks from the region, while British banks were out by the early 2000s. HSBC sold its last branch network in Cayman this year. Is it now the turn of the Canadians? The stronger regulatory environment and the more onerous reporting requirements that exist today have made it difficult to manage branches from the metropolitan centres, making them unattractive owing to reduced competitiveness, resulting in poor performances.

It is clear that the mass market tourism model is unsustainable in the Caribbean, given our small scale and high operating costs. To enhance the viability of the sector, operators should focus more on niche markets and the high-end segment. In the current environment, high occupancy levels are being reported primarily by the high-end operators such as Sandals Resort and Spice Island while the mass market operators continue to struggle. With high labour costs and expensive energy supplies, the regional tourism sector -which is energy intensive-, is finding it difficult to remain competitive. Most destinations in the region rely primarily on oil for energy generation purposes, rather than the much cheaper gas fueled power generation grids found in Trinidad and Tobago and the Dominican Republic. In a situation where tourism destinations around the world derive electricity from cheaper and more

Figure 2: Wage Bill 2013/2014 (% of Current Revenue)



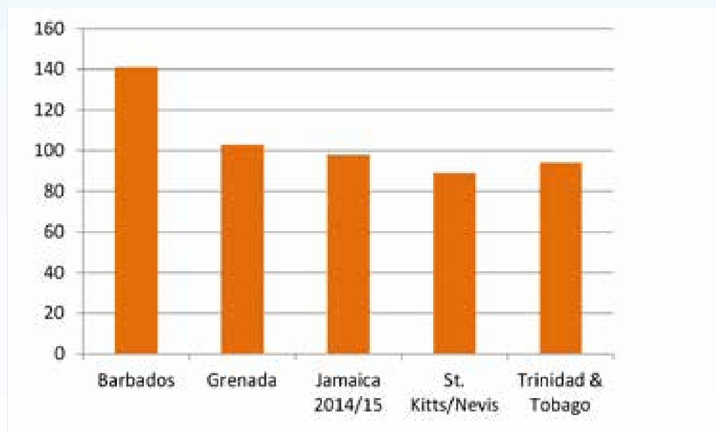
Sources: Central Bank of Barbados, Central Bank of Trinidad & Tobago, Central Bank of Jamaica & International Monetary Fund

efficient fuel sources or have scale, the Caribbean, using the current model is likely to remain relatively uncompetitive. According to the Caribbean Centre for Money and Finance, the Caribbean's market share, compared to the rest of the Americas has been in decline. On the other hand, Central and South America have seen their market share grow between 1990 and 2011. When we look at CARICOM countries, in the context of the entire Caribbean the trend is the same. In 1990, CARICOM nations received 34 percent of all international visitors to the Caribbean. By 2000, this figure fell to 28 percent, before slumping further to 22 percent in 2011. Conversely, Cuba and the Dominican Republic experienced significant market share growth during the period.

Weighed down by surging energy costs, several Caribbean nations sought refuge in PetroCaribe, an energy-assistance programme for the Caribbean and Central America, launched by the late Venezuelan President, Hugo Chávez, in 2005. The programme allows Caribbean states to take fuel from Venezuela, but only pay a portion of the cost up front, with the remainder being converted to long-term loans. This consistently adds to the region's stock of debt, which is already at unsustainable levels. The Economist Magazine revealed that Jamaica, Guyana and Haiti deferred payments to Venezuela that were equivalent to 4 percent of GDP and greater than 10 percent of government revenue, annually between 2011 and 2013. During the period, Antigua and Barbuda deferred payment equivalent to 2 percent of GDP, while Grenada and Dominica added just below 2 percent annually to their respective debt figures under the programme. Since the PetroCaribe agreement permits these regional states to consume a level of fuel they ordinarily could not afford, policy makers have not felt a significant sense of urgency to address the woes of the energy sector. With Venezuela now finding it difficult to supply basic goods to its citizens and with the country facing severe and deteriorating fiscal deficits, the PetroCaribe programme has been called into question. One suspects that President Nicolás Maduro will face mounting pressure to wind up the programme until the situation in Venezuela drastically improves. From a Caribbean perspective, many regional states now find that their economic prospects are dependent on what is essentially a failed or failing state. This is a less than ideal situation, which is deeply disturbing, to say the least. In light of the recent fall in the price of oil to US$77 per barrel, after averaging over US$100 for an extended period, the IMF has advised Caribbean countries to put contingencies in place to cater for possible interruptions or a complete halt of PetroCaribe.

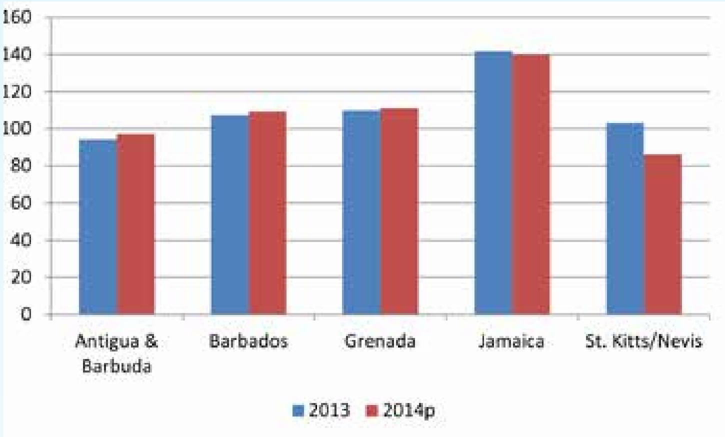
The world is constantly changing. Nowhere is change more evident than in the way business is conducted. Innovators have now become disruptors and have transformed (disrupted) many industries including banking, newspaper, telecommunications and entertainment. One disruptor Uber has significantly impacted the taxi business in over 200 cities around the world. The company was launched only in 2009 and connects commuters with nearby pre-registered cab drivers through a mobile application. Usually, passengers are picked up within minutes of confirming a ride. They are in the process of disrupting taxi industries the world over. Innovators have also disrupted book publishing and the music industry. They are succeeding in getting more and more households to abandon hard-wire telephone services and steady improvements in mobile and internet phone technology make it a matter of time until traditional phones become a quaint relic. Hydraulic Fracturing (fracking) technology has disrupted the oil trade. By driving down transport and communication costs, disruptors have transformed the clothing, furniture and untold other industries. They have virtually wiped out the travel agency business, replacing them with something called APPS. Neflix is about to disrupt the cable and satellite providers of television. The credit card industry is even about to be disrupted with the likes of Apple pay. Such changes are part of the natural evolution of economic activity. The Caribbean is used to economic changes, having moved from mainstay industries such as sea island cotton, cocoa and sugar. What is important is that the region recognizes we are in a tumultuous period of rapid disruptive change and the need to re-invent itself before it is too late. We all know change is coming but then all of a sudden it happens.

Figure 3: Current Expenditure 2013/2014 (% of Current Revenue)



Sources: Central Bank of Barbados, Central Bank of Trinidad & Tobago, Central Bank of Jamaica & International Monetary Fund

Figure 4: Public Debt (% of GDP)



Sources: Central Bank of Barbados & International Monetary Fund

It will be a major oversight not to mention some of the good things that are taking place throughout the region. One example is the Cayman Islands' foray into medical tourism. In February this year, Health City Cayman Islands (HCCI) a 104-bed hospital was officially opened. The facility is the fruit of the vision of Dr. Devi Prasad Shetty, renowned cardiologist and founder of Narayana Health (NH), who has opened many similar institutions in his native India. Health City will provide cardiac, cardiology and orthopedic services at competitive prices to international and local patients. The hospital is expected to eventually expand to 2,000 beds. In five years time, they expect 15,000 persons, in doctors, patients, nurses, care giver etc to be on the island benefiting from this. The Cayman Islands has a population of approximately 50,000 at present. This has relevance for islands with sizeable medical schools where such a venture would be a natural fit providing a teaching hospital and research facilities. Yachting, particularly luxury yachts hold much potential for tourism development when an adequate number of large mariners are in place.

In energy, several nations in the region have begun exploring renewable energy alternatives. Aruba is well ahead of its peers in this regard, benefitting from significant cost savings by investing in wind energy. The country has seen its fuel consumption cut in half since 2012. Barbados has already made laudable strides to reduce its dependence on fossil fuels. It is estimated that 30,000 households in the country have solar water heaters, while government buildings and commercial enterprises have also turned to photovoltaic resources to reduce energy costs. Prime Minister Freundel Stuart stated that Barbados plans to produce 29 percent of its energy from renewable sources by the end of the next decade. Other countries in the region are exploring the potential of geo-thermal energy.

Perhaps the most frustrating thing about the region's challenges is that much of what is required to effect meaningful change is within our control. For instance, it is by no means impossible for Caribbean governments to implement initiatives to reduce the role of the public sector in the economy. Of course, this policy must be complemented by significant incentives to encourage private sector led growth. What about fiscal neutrality? Is it too much to ask elected officials to manage public funds more prudently and thus, turn away from deficit financing? Why can't the Caribbean focus on niche market tourism and IQ-intensive industries? Is downstream diversification too hefty a goal for Guyana and Trinidad and Tobago? If we revise the interest rate regime and in particular, eliminate minimum deposit rates that exist in some jurisdictions, will not some of the shackles that bind the financial sector be broken? Not one of these things is beyond our capabilities, yet we perpetuate the philosophies and activities that maintain the status-quo. We have become quite adept at identifying the underlying causes for the region's structural deficiencies, but less competent at taking credible, sustained action to put things right. For this reason, the region continues to be blighted by unsustainable fiscal accounts and growth well below potential. Within the financial sector, investment by foreign banks in the Caribbean is receding, while indigenous banks are left holding on to stocks of non-productive loans and have inadequate capital to fill the void. In view of this, it is not surprising that the OECS banking sector is as stated, in need of re-capitalization. The model is indeed broken. Let us hope for the region's sake that our will to take corrective action is not as well.