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Where are all the Greenbacks?

Have you gone to your bank lately to purchase US Dollar (USD)? If you have, you may have been turned down for the full amount you requested and offered to be put in the infamous "queue". In fact the queue does exist and it is reported to the Central Bank of Trinidad and Tobago (CBTT) by all commercial banks. This report is used to determine the shortfall of supply of USD in the market and aids in the CBTT's decision regarding the amount of USD to sell to the market via the banks: This is referred to as the Unsettled Demand. However, the CBTT also has the responsibility of protecting the local currency and as such releases USD in a measured manner so as not to add excessive downward pressure on the TTD nor decrease the level of foreign exchange reserves which are already under threat due to the economic downturn. But why is there sometimes such a gap between the demand and supply of foreign currency in Trinidad and Tobago?

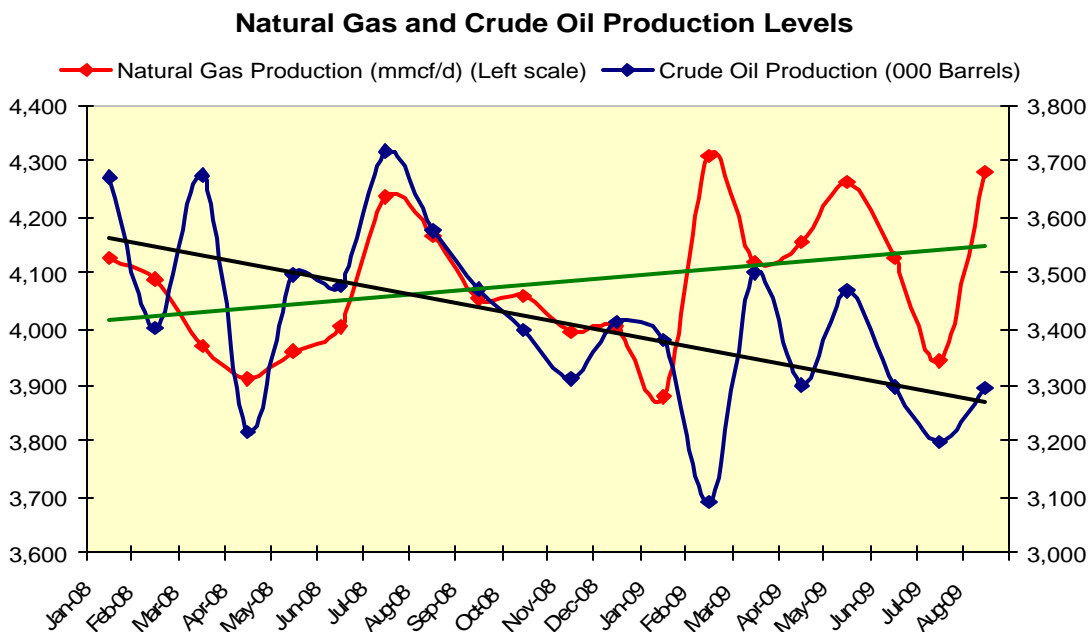
The global financial and subsequent economic crisis of the past year and a half has had its fair share of negative implications on the Trinidad and Tobago (T&T) economy. Indeed macro economic fundamentals for T&T have displayed a marked deterioration for 2009 thus far, and it appears that the outlook for the rest of the year and into 2010 is not promising as well, as there will be a lag from when the global economy starts to recover for the trickle down effects to 'take root' locally. The energy sector is the biggest contributor to the country's GDP, accounting for around 43% of the country's GDP, more than 50% of government revenue and 90% of total exports. Economic and export diversity, or lack thereof, have always been issues of concern as they leave the economy exposed to the vagaries of the global markets. Not only can this result in a significant turn in the macroeconomic fortunes of the country, but it can also affect the financial system, especially if that single sector is the major source of foreign exchange inflows.

The CBTT has the responsibility of undertaking interventions as required to promote stability in the foreign exchange (FX) market, which can mean buying/selling FX from/to commercial banks as well as non-banks to preserve both the stability in that market, as well as the value of the TT dollar. In 1993, the CBTT introduced a sharing arrangement whereby foreign exchange receipts of some major suppliers in the energy sector would be shared among the bank: This market is now experiencing severe pressure. The supply of USD has tightened considerably given the state of the major suppliers of FX in the energy sector. Indeed, the demand for USD in T&T has far outweighed the supply, to the extent that the CBTT has consistently intervened in the market to help alleviate some of this imbalance. The data show that for the period January to October 2009, the CBTT intensified its interventions in the market, selling USD1.389 billion to the market. This represents a 133% increase over the corresponding period of 2008.

This strain arguably stems from the supply side primarily the major suppliers of FX (the energy companies) as they have

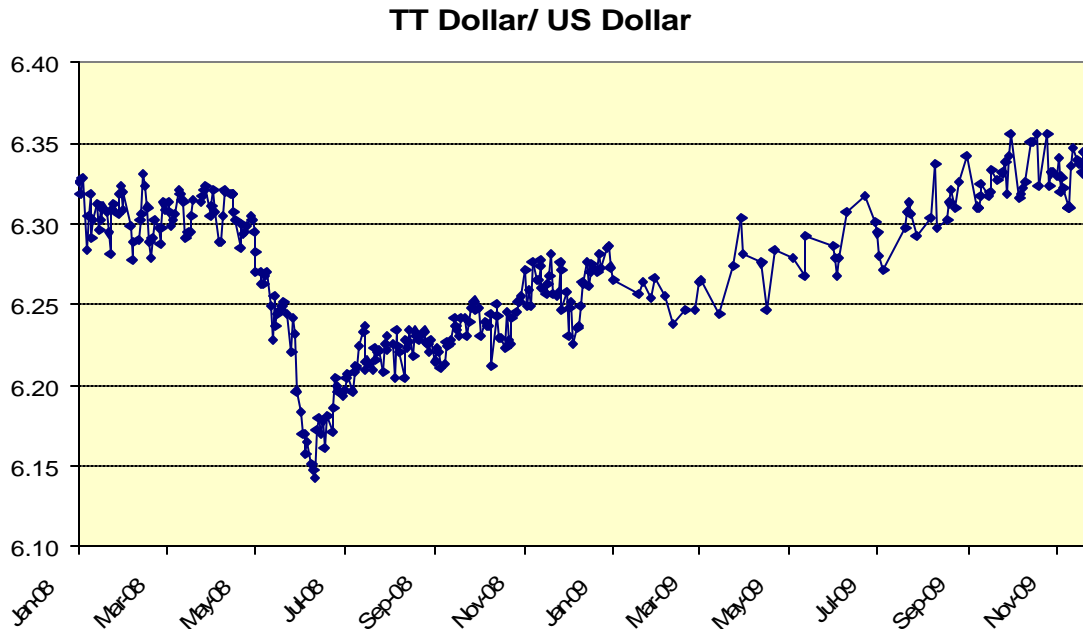
experienced a shortfall in revenue due to the decline of their output prices. Figure 1 shows the production levels of selected energy commodities in T&T since 2008, on a monthly basis. The green line represents the trend line for natural gas, while the black line shows the trend for crude oil production. It is clear that crude oil production is on a declining path, while natural gas is charting an upward trajectory. Even though natural gas output is on the rise, the main issue is that prices are not moving in sync with general commodity prices on the international market. There have been some concerns about over-supply of natural gas as well as stronger demand for natural gas alternatives with both of these factors keeping investors bearish on this commodity, despite the bullish sentiments of other commodities such as crude and gold.

Figure 1: (Source: Bloomberg)



The absence of a true recovery of natural gas prices has severe repercussions for T&T, given the shift from being an oil-based economy to one now more reliant on gas. This suggests that foreign exchange inflows will remain tight for some time to come, until there is a notable rebound in the global demand for natural gas. For the period January – October 2009, the energy sector accounted for 58% of total commercial banks’ purchases of foreign exchange, and for the same period, the purchases from the energy sector fell by 28% (year-on-year). The slowdown in the non-energy sector was also reflected in the decline of this sector’s supply of FX, which declined by 49% during the same period, compared to the corresponding period a year earlier. The unevenness in the FX market has resulted in some volatility in the TTD’s conversion rate to the US currency. Figure 2 shows the movements of the domestic currency to the USD since the beginning of 2008. For the year 2009 thus far, the TT dollar has lost 1.24% of its value against the US dollar trading at an average rate of TTD6.3069 to the USD, compared to an average of TTD6.2563 in 2008. One reason which may be attributed to the depreciation of the TTD against the USD is the easing of monetary policy in T&T. The CBTT has cut the policy interest rate by a cumulative 300 basis points for 2009 thus far. Additionally, the TTD yield curve has displayed a notable downward shift. The implication of this has been a narrowing of the interest rate differential between TTD and USD assets, which would have lowered demand for TTD assets and by extension the TTD (relative to the USD).

Figure 2: (Source: Bloomberg)

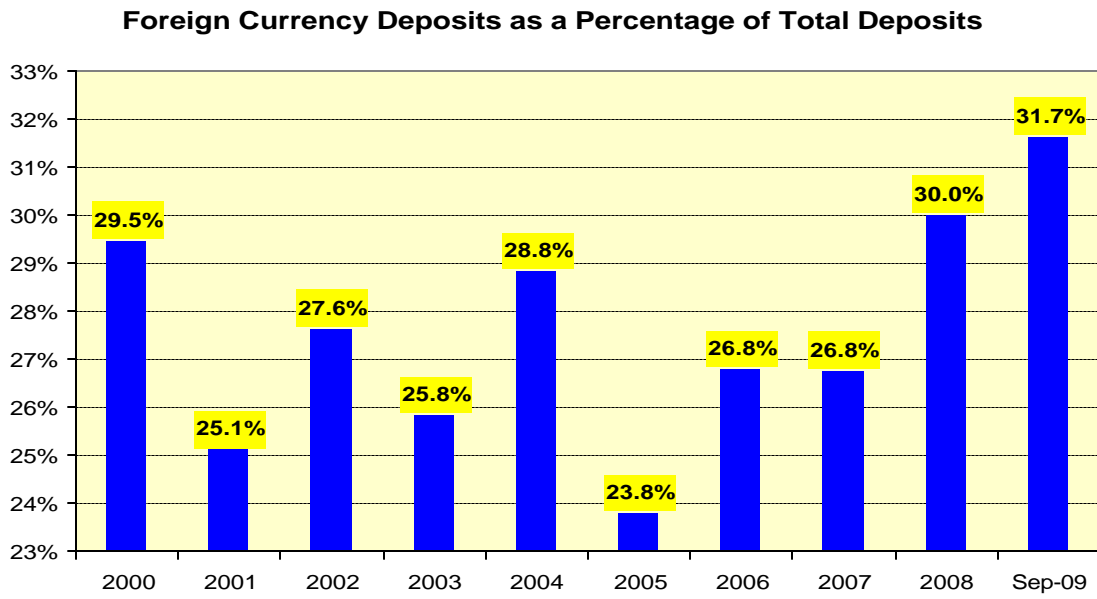


While there are significant supply constraint factors, there are also demand factors which are tempering, to a certain degree, the pressures in the FX market. Data show that imports have declined 31%, year-on-year for the period January – June 2009, both for energy as well as non-energy imports. Non-energy imports slowed almost 20% for the same period, primarily as a result of the slowdown in the pace of execution of the government’s infrastructural projects.

We should not forget that the CBTT must take all of the above into consideration while trying to balance the country’s need for foreign currency reserves. The CBTT cannot succumb to all these demands to release the total required USD into the market that is necessary to bring the unsettled demand down to zero. If the CBTT was to intervene in the market to this extent, then the consequences for the T&T economy would be dire. Not only will it add ‘depreciatory’ pressures on the TTD, but another implication of such action by the CBTT will be the rapid erosion of the country’s stock of external buffers – i.e. its foreign currency reserves. Careful management of these reserves is essential to reduce the country’s vulnerability to exogenous shocks.

The FX market is an important element in the T&T financial system - the percentage of foreign deposits to total deposits in commercial banks has increased from 23.8% in 2005 to 31.7% at the end of September 2009 (See figure 3). In addition to this, despite the sharp downturn in imports, many multinational and local corporations require large amounts of USD to meet financial obligations, royalties, taxes etc. on a frequent basis, which will add to the already high demand, amid very short USD supply. As a country heavily dependent upon the external environment, managing the pressures on the FX market becomes even more important, especially operating within the context of a ‘managed’ exchange rate regime, where significant pressures in the market can upset the equilibrium resulting in rapid erosion of foreign exchange reserves if not carefully monitored. For these reasons, the CBTT’s responsibility in preserving the stability in the FX market is vital to the country’s fundamental health as it has far reaching effects.

Figure 3: (Source: Central Bank of Trinidad and Tobago, CMMB Research Center)



FINANCIAL & ECONOMIC INDICATORS

As at 26 November, 2009

Exchange Rate/US\$	Closing Value	Previous Week
Yen	86.59	88.97
Euro	1.50	1.49
Jamaica	88.98	89.39
Guyana	202.70	204.40

Commodity Prices	Closing Value	Previous Week
Crude oil (US\$/bbl)	N/A	77.46
Natural Gas (US\$/mmbtu)	N/A	3.56
Gold (US\$/Troy Ounce)	1,188.38	1,144.60

Eurobond Indices (As at 26-11-09)

Lehman Brothers Global Aggregate Index (Return % YTD)	10.80
JP Morgan EMBI+ (Basis points)	311
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	33.95

Policy Interest Rates (%)	Closing Value	Previous Week
United States	N/A	0.15
Euro Zone	1.00	1.00
Japan	0.10	0.11
Brazil	8.75	8.75
Trinidad	5.75	6.25
Jamaica	12.50	12.50
Barbados	2.50	2.50

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	0.04	0.01
US 10-Yr Treasury	3.28	3.34
3-month UK Libor	0.61	0.61
Japan 90-day T-Bill	0.11	0.11
Brazil 90-day T-Bill	8.65	8.65
TT 90-day T-Bill	1.46	1.46
Jamaica 90-day T-Bill	16.21	16.21
Barbados 90-day T-Bill	3.48	3.48

Sources: Bloomberg, J.P. Morgan, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, www.lehman.com

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