Issue #4 October 2006

CMMB Emerging Markets Weekly

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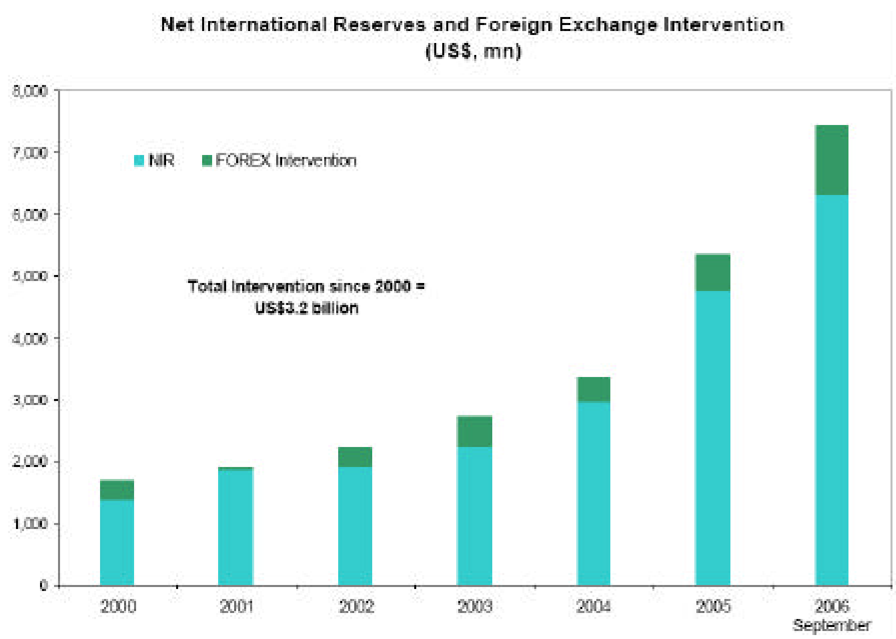
TT Exchange Rate Stability: Reality or Phyricc Victory

Trinidad and Tobago is boasting a strong balance of payments performance but businessmen are repeatedly complaining about the chronic shortage of foreign exchange. Over the past year or so, we have been witnessing prominent signs that nominal exchange stability is less a reality and more a phyricc victory, a victory at great loss. Some of these signs include:

- The TT dollar crossing the psychological barrier of TT$6.29 per US$ in late 2005, reawakening the devaluation jumbie.

- The Central Bank selling a record US$1.1 billion so far in 2006 to quell unsatisfied demand for foreign exchange, and the busiest two months of November and December are still to come. In 2005, the CBTT sold US$500 million in foreign exchange to commercial banks.

Figure 1: Accumulation of Net International Reserves In Trinidad and Tobago



- Central Bank Governor Williams candidly raising capital flight as a worrying source of undue pressure on the foreign exchange market, and wondering about ways to control these unidentified capital outflows.

- Inflation, pushed by forces outside the Central Bank's span of control, set to reach double digits by the end of 2006.

The foreign exchange market has been liberalized for nearly fourteen years. And the authorities are still repeating the policy mistakes of the past. The Central Bank is supposed to be running a managed float with respect to ALL currencies. In reality, it operates a de facto fixed peg in relation to the US dollar but a float with respect to other currencies. For extended periods, the TT dollar has remained within a uniform selling level to the US dollar – TT$5.99 between April 1993 to September 1996 and TT$6.29 for the past decade – even though recurrent pressures exist in the foreign exchange market. Quite naturally we have become accustomed to these official thresholds, which reinforce our expectations that a dreaded "devaluation" is just around the corner, especially when demand for foreign exchange worsens, queues lengthen, and rationing becomes the order of the day, as currently prevails.

As in the previous oil boom in the mid-1970s to early 1980s, the current energy boom is generating tremendous real currency appreciation, which is eroding the competitiveness of the non-energy sector. The ravages of the Dutch Disease are transforming Trinidad & Tobago from Caribbean tiger to Caribbean pussycat. By 2005, our global competitiveness ranking had tumbled to 67th position from 31st position in 2001. The 2006/2007 Budget identifies seven key sectors for industrial development – Yachting; Fish and Fish Processing; Merchant Marine; Music and Entertainment; Film; Food and Beverages; and Printing and Packaging. But how many of these targeted non-energy industries will become viable over the next few years without the prop of government subsidies? How many will become net generators of foreign exchange rather than net users of foreign exchange?

Fiscal dominance is revealing the glaring inconsistency of the current exchange rate regime with inflation control. Although rising energy revenues have improved the government's balance sheet, an even more rapid increase in public spending has worsened the underlying budgetary position. The non-energy fiscal deficit is projected to reach over 20% of non-energy GDP in FY 2006/2007, up from 8% in FY 1998/1999. Monetization of the non-energy deficit remains the major catalyst for pushing liquidity into the financial system. The classic result is too much money chasing too few goods. This has placed an unfair burden on monetary management and poses a serious risk to the control of inflation, which could soon reach beyond 10% by the end of 2006.

The policy conflicts between nominal exchange rate stability, external competitiveness and inflation control are starting to narrow the range of choices for the Central Bank. It will soon have to realistically assess options for the future arrangement of exchange rate policy.

There are three (3) potential options:

- **Adopt a hard peg.** Ideally, this could take the form of a radical move to official dollarization (adopting the US$ as legal tender), which eliminates the risk of currency and balance of payments crises. A government cannot devalue a currency that does not exist. Dollarization forces the government to strive for fiscal discipline because it can no longer print money to finance deficit spending. Alternatively, the hard peg could entail a move to a currency board, the most successful model of which is the Eastern Caribbean Currency Union. As the Caribbean's leading economy, Trinidad & Tobago adopting a currency board arrangement could provide a much needed shot in the arm to monetary integration, helping to catalyze the “economy” aspect of the CSME.

- **Move to more flexible rate arrangements.** On 11 October 2006, the IMF Executive Board concluded its Article IV Consultation with Trinidad & Tobago, once again encouraging the authorities to consider greater exchange rate flexibility in the event that high energy prices persist over the medium term. Yet, we have an ingrained cultural “fear of floating” linked to the massive currency devaluations in the late 1980s and early 1990s.

- **Impose capital controls.** This will allow the Central Bank to conduct an independent monetary policy while maintaining the rigid exchange rate peg. While intuitively appealing, any re-imposition of capital controls would not only represent a policy reversal of the 1993 decision to fully liberalize capital movements but would also be inconsistent with Trinidad & Tobago’s quest to become an international financial centre.

In the end, choosing an exchange rate regime is a political act. Overcoming our phobia is very difficult, but not impossible, if we are to claim more than a Phyricc exchange rate victory.

FINANCIAL & ECONOMIC INDICATORS
As at 26th October 2006

Exchange Rate/US$	Closing Value	Previous Week
Yen	118.38	118.15
Euro	1.27	1.26
Jamaica	66.18	66.17
Guyana	201.40	201.40

Commodity Prices	Closing Value	Previous Week
Crude oil (US$/bbl)	60.36	58.50
Natural Gas (US$/mmbtu)	7.91	6.08
Gold (US$/Troy Ounce)	597.15	599.40

Eurobond Indices (Returns, % YTD as of 26- Oct- 06)	
Lehman Brothers Global Aggregate Index	2.63
JP Morgan EMBI+	-23.01
CMMB Eurobond Index	2.43

Policy Interest Rates (%)	Closing Value	Previous Month
United States	5.25	5.25
Euro Zone	3.25	3.25
Japan	0.25	0.25
Brazil	13.75	13.75
Trinidad	8.00	8.00
Jamaica	11.95	11.95
Barbados	4.75	4.75

Market Interest Rates (%)	Closing Value	Previous Week
US 90-day T-Bill	4.99	4.96
US 10-Yr Treasury	4.72	4.79
3-month UK Libor	5.18	5.13
Japan 90-day T-Bill	0.28	0.28
Brazil 90-day T-Bill	13.70	13.43
TT 90-day T-Bill	6.72	6.71
Jamaica 90-day T-Bill	11.77	12.06
Barbados 90-day T-Bill	6.21	6.03

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