



## *Is a TT Dollar Devaluation Imminent?*

The stability of the TT dollar (TTD) and the current 'peg' to the US dollar (USD) has come under much scrutiny in the recent past, to the extent that some are demanding that government state its intention concerning the current exchange rate of approximately TTD 6.2999 per 1 USD. It seems that many are convinced that the TT dollar is heading for devaluation. It has not been quantified, yet I get the impression that a portion of our citizens have a great fear of this type of action.

First of all, it is important to understand the type of exchange rate regime that Trinidad & Tobago has adopted. The two that most are familiar with are the fixed and floating exchange rates systems. For the most part, our regime may be described as a 'managed float', which basically means that the TTD floats against the US dollar but trades within a tight band, which it can change from time to time. This is why you typically see the selling rate of the US dollar range, for example, from 6.27 to 6.31. Usually, this is based on supply and demand. That is, when there are more US dollars available to the market, its selling price is closer to the lower bound compared to when the currency is 'short', or less abundant, then the rate moves upwards. As such, our TT currency is 'managed' within a range.

The last year has been very interesting as the major economies of the world have found themselves entering into periods of recession and record lows, whether we talk about commodity prices, other asset prices, or key economic indicators like employment, growth, etc. These shocks have indeed affected Trinidad and Tobago; about 60% of the government's revenue is generated in the energy sector, and this is expected to be significantly diminished, given the sharp reversal in energy prices on the international market. In this context, it may seem necessary that the managed float may need adjustment.

Deciding on the optimal exchange rate is not an easy task. There are several factors that must be considered and even then that does not guarantee it would be set at the equilibrium level. The simplest model is that of Purchasing Power Parity (PPP). The idea is that the equilibrium exchange rate is proportional to the relative price levels of the home country and the foreign country. This serves as a good indicator because it employs relative inflation rates to determine the change of the nominal exchange rate. Therefore, the higher the domestic inflation rate, the greater will be the proportional depreciation in the domestic exchange rate. At this point some may be quick to jump to the conclusion that as we have high inflation, 11.7%, our currency will have to adjust accordingly and thus depreciate. That may be true in theory for a purely floating currency but let's not jump to any conclusions just yet.

Changes in the real exchange rate are also caused by different types of external and domestic shocks. Output can be generated from two sectors, the tradable and non-tradables. We can think of tradables as the goods that can be sold on the international market and delivered to different geographic locations, such as commodities. Non-tradables can be considered then as houses and perishable items. In other words, non-tradables are goods and services that are both produced and consumed domestically that are not substitutes for imported or exported goods and services. If productivity rises faster in the tradable sector than in the non-tradable then the exchange rate appreciates as more resources will be allocated towards the tradable sector. As a result the trade balance improves. The trade balance is also another determining factor for exchange rates. When the relative prices of the exports fall compared to imports, demand for domestic currency deteriorates and as such the domestic currency depreciates. Tariffs play a role as well. The reduction of a tariff is deemed as an improvement to a country's terms of trade. This effect lowers the prices of imports, which in turn increases demand on imports which would depreciate the domestic currency.

Government actions with respect to tax policies and spending also lend a hand to exchange rate movements. If spending is focused on items that have to be imported then this too would add to the depreciation of the currency. Spending also occurs, in infrastructure for example, which creates employment and may create an inflationary environment. Interest rates can have either an appreciation or depreciation effect on the currency, depending on the direction they are heading. An increase in domestic interest rates tends to appreciate the currency as foreign inflows increase. However, in a pegged arrangement, domestic interest rates are not free to move to act as an automatic stabilizer but must remain at a stable level relative to the interest rate of the foreign country whose currency it is pegged to. As a result, domestic interest rates in this case would tend to move in the same direction as rates in the foreign country.

Mexico in December 1994 devalued their currency, due to poor fundamentals, high interest rates, capital flight and speculative attacks which dwindled the level of reserves and subsequently ended in the peso's fixed rate demise. While the TT currency is not under speculative attacks and we seem to have a solid foreign exchange reserves level it does not seem immediately necessary to follow Mexico's footsteps and freely float our currency, essentially, devaluing the TTD given the excess demand for US dollars and the drop in the supply coupled with the decreased in foreign exchange revenue due to the current prices of commodities i.e. energy.

Currently, it seems that we are not in any grave danger. The country that we are pegged to, United States of America, has aggressively lowered its interest rate, as such TT interest rates should fall too. Considering the inflation data, we may not be in a position to lower our domestic interest rates too quickly without sterilization. We have already begun to observe our Treasury-Bill yields come down. Some other combination of policy changes will be necessary.

Pegged (fixed) regimes reduce the effectiveness of monetary policy. It seems that government spending policies ought to be adjusted, whether it actually will be is left to be seen. Inflationary pressures still exist and demand is still relatively high for tradables and imports. For these reasons, currency intervention would not make sense at this point. When the US went through their rate hiking period our rates adjusted very slowly while our currency ranged for the most part within the band. As the reverse has occurred in a much shorter time frame, we can expect some short-run imbalances but the currency should continue to trade within the band.

This is a period where our main export is at a lower price and as a result, we are receiving less foreign exchange inflows compared to the preceding years. The supply and availability of US dollars has naturally decreased. The excess demand

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for US dollars has generated the idea that our currency has to devalue. This may not be the case as there are other factors at work, as capital flight is not a significant issue, nor do we have massive speculation on the currency.

A more realistic worse-case scenario may be that the band in which our currency 'floats' has to be widened so as to allow the TT dollar to attain a lower value while protecting our reserves as we adjust to the new market pressures. A depreciation of our currency may help improve our current fundamentals as we go through (and we will), a period of economic slowdown, in the short-term.

This may not be all bad as we have to consider the effect of a slightly weaker currency. Imports will become more expensive and improve the trade balance. Domestic demand should fall and prices will adjust downwards to return to equilibrium levels which will help our inflation rate. When the global economy recovers, demand for our exports will add positive pressure to the currency and help appreciation. This will increase external demand which will increase domestic production and will translate to more employment. Government will still need to maintain a lower level of spending so as not to jumpstart inflation too quickly. In the short-run, the effect of the currency acting as a stabilizer may be perceived negatively by the public but the long-run effect would be for sustained growth and demand for our exports, increased FDI, strengthening of the current account and an overall stronger economy. Our inflow and availability of foreign currency will increase. This overall process eliminates the need for a one time major devaluation.

A devaluation of the TT dollar does not seem imminent at this point in time. It may be that some of the factors that affect exchange rate are temporarily pointing some of us towards that conclusion. Adjustment takes time and the policies involved to make these adjustments also take time to take affect due to inside and outside lags (time it takes for government to respond to a shock and for the response to take effect). Patience and careful management of our country's fundamentals will determine the proper course of action needed.

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**FINANCIAL & ECONOMIC INDICATORS**  
As at 12 March, 2009

<u>Exchange Rate/US\$</u>	<u>Closing Value</u>	<u>Previous Week</u>
Yen	97.72	98.07
Euro	1.29	1.25
Jamaica	88.25	88.20
Guyana	204.40	204.90

<u>Commodity Prices</u>	<u>Closing Value</u>	<u>Previous Week</u>
Crude oil (US\$/bbl)	47.03	43.61
Natural Gas (US\$/mmbtu)	3.88	4.21
Gold (US\$/Troy Ounce)	926.63	932.40

**Eurobond Indices (As at 12-March-09)**

Lehman Brothers Global Aggregate Index (Return % YTD)	-5.13
JP Morgan EMBI+ (Basis points)	662
JP Morgan Central America and Caribbean Index (CACI) (YTD return %)	2.14

<u>Policy Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
United States	0-0.25	0-0.25
Euro Zone	1.50	1.50
Japan	0.10	0.10
Brazil	11.25	12.75
Trinidad	8.75	8.75
Jamaica	17.00	17.00
Barbados	3.00	3.00

<u>Market Interest Rates (%)</u>	<u>Closing Value</u>	<u>Previous Week</u>
US 90-day T-Bill	0.19	0.19
US 10-Yr Treasury	2.85	2.81
3-month UK Libor	1.87	1.99
Japan 90-day T-Bill	0.37	0.38
Brazil 90-day T-Bill	11.08	11.83
TT 90-day T-Bill	3.94	3.98
Jamaica 90-day T-Bill	21.69	21.69
Barbados 90-day T-Bill	3.84	3.84

Sources: Bloomberg, CMMB, Central Bank of Trinidad and Tobago, Bank of Jamaica, Central Bank of Barbados, [www.lehman.com](http://www.lehman.com)

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