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TRINIDAD & TOBAGO BALANCE OF PAYMENTS RISK

Why T&T could be heading to default and a balance of payments crisis by end-2022

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T&T is at risk of a default / balance of payments crisis by end-2022. Here's why:

Already, T&T is one of the most difficult places in the Caribbean to source USD. A balance of payments crisis occurs when a country does not have enough foreign currency to meet its foreign currency denominated obligations, either debt or otherwise. Our declining FX reserves (and Heritage and Stabilization Fund) in the context of rising debt and persistent weakness in our exports, suggest that at some point we will run out of foreign currency, if nothing is done.

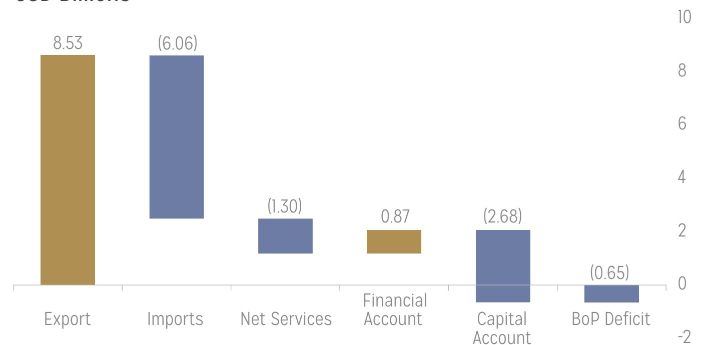
It is important to point out that while the Heritage and Stabilization Fund (HSF) was never designed to be used to defend the exchange rate, given the recent legislative amendment that allows the Minister of Finance to access the fund to the tune of USD1.5 billion in a crisis (with no legislated limit on frequency of USD1.5 billion drawdown), there is little doubt that the HSF will be used to augment the level of FX reserves. The cumulative contributions of the Government to the HSF have only been USD2.5 billion since inception, with the remainder being earned by the fund manager. The balance on the HSF is currently about USD6 billion, which could provide maybe seven months of import cover, but no new Government contributions have been made in the last six fiscal years, meaning the fund has only grown through portfolio performance. Combined, the HSF and the level of FX reserves currently provide about 14-15 months of import cover, and as argued below, unless the policy stance of the Government changes, T&T could run out of foreign exchange in about two years.

BALANCE OF PAYMENTS

The Balance of Payments account captures all the foreign currency transactions a country makes with the rest of the world: imports, exports, remittances, foreign direct investment, etc. The net effect of all these foreign exchange transactions is reflected in the change to the level of FX reserves held at the Central Bank - if we earn foreign currency, FX reserves increase, if we lose foreign currency, FX reserves decline.

In 2019, despite the fact that we exported more than we imported, the net outflow of capital left us with a net negative position on the Balance of Payments account, and therefore a decline in the level of FX reserves.

Balance of Payments 2019: Trinidad & Tobago
USD Billions

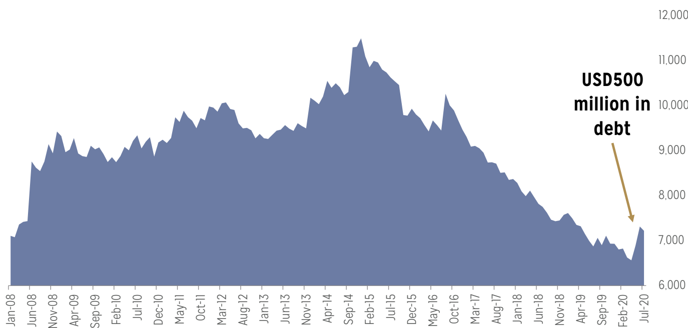


Source: Central Bank of Trinidad & Tobago, Marla Dukharan

FOREIGN EXCHANGE RESERVES

Our FX reserves have been steadily declining since December 2014, when it had reached an all-time high of USD11.5 billion or 13 months of import cover. The level of FX reserves now stands around USD7.2 billion, returning to the level of February / March 2008, following an uptick from the June 2020 USD500 million bond issue. This USD7.2 billion level represents a decline of 37% from the all-time high in December 2014. If we back out the impact of USD500 million in debt issued in June 2020, and look at what has been earned organically by our economy, we can see that we have been losing on average over USD70 million per month for over five years. This is not a sustainable situation, and it will end in default / Balance of Payments crisis if maintained.

Net Official Reserves: Trinidad and Tobago
USD Millions



Source: Central Bank of Trinidad and Tobago, Marla Dukharan

The reasons for our steadily declining FX reserves, which will ultimately drive a balance of payments crisis if nothing changes, are long standing but not irreversible:

· The wide and growing fiscal deficit and higher debt

· The grossly overvalued TTD and other harmful FX policies

· The shrinking non-energy sector

· Energy sector weakness

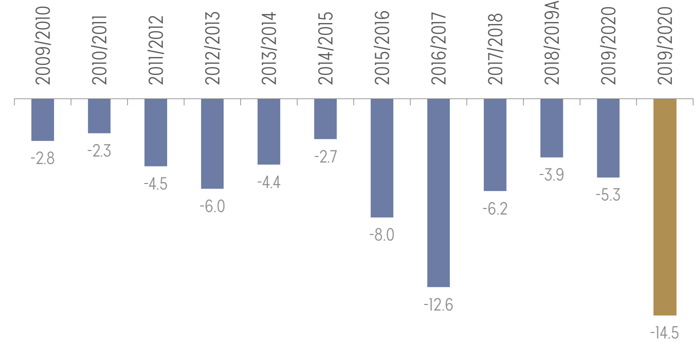
· The net outflow of capital

· The large and consistently negative net errors and omissions item of the Balance of Payments

1. Wide and growing fiscal deficit and higher debt

Since the Government is the largest economic actor in T&T, the major driver of imports overall, is Government spending. If we assume that, like the rest of the Caribbean, 80-90% of what we consume is imported, it means that the Government, as the largest spender in the economy, and the largest single employer, is therefore the largest driver of imports. And the persistent fiscal deficit means we are essentially borrowing to import. Therefore, balancing the fiscal budget is probably the single most important factor in reducing the level of imports and stemming the decline in the level of FX reserves.

Total Deficit Trinidad and Tobago
TTD Billions

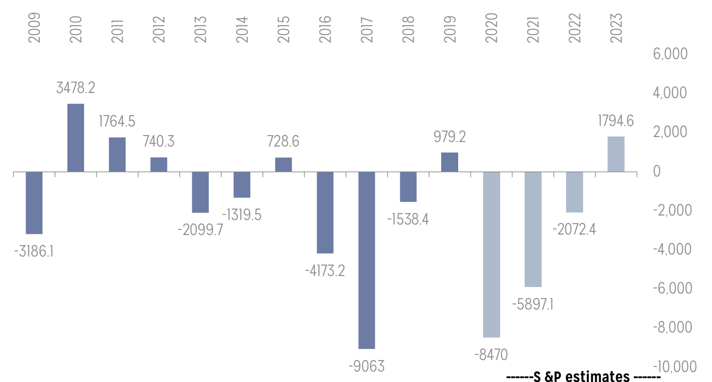


Source: Review of the Economy & Budget Statement, Min. of Finance Mid-Year Budget Review, Marla Dukharan

In T&T, not only do we run consistent fiscal deficits but we also carry primary fiscal deficits, meaning we are already in deficit even before we pay the interest on our existing debt. This means that essentially, we are borrowing to pay interest on existing debt.

On average, between FY 2008/2009 and FY 2018/2019, we were TTD1.24 billion per year in the red before paying the interest on our debt, which is not sustainable. In the context of COVID-19, the primary deficit will increase even further, with S&P projecting it to reach TTD8.5 billion this fiscal year, and Moody's projecting TTD9.9 billion.

Primary Fiscal Balance: Trinidad and Tobago
TTD Billions by Fiscal Year



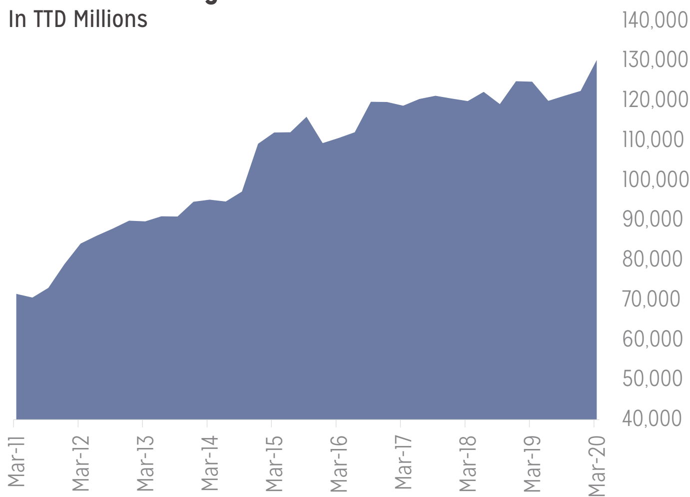
Source: Central Bank of Trinidad & Tobago, S&P Global, Review of the Economy & Budget Statement, Min. of Finance, Marla Dukharan

Our gross public sector debt rose 4.4% y/y in March 2020 - before COVID - and grew 82% since March 2011. This means we are taking on, on average, an additional TTD1.6 billion in

debt every 3 months. Gross public sector debt to GDP stood at 79.3% in March 2020 (TTD130 billion) and net public sector debt 68%. We know that just by virtue of the fact that the economy has certainly shrunk in 2020, these ratios would have grown, and also the numerator has increased based on Government borrowing.

Research by the IDB suggests the sustainability threshold of debt in the Caribbean is around 56% of GDP, and that after this point, every dollar of additional debt causes the economy to contract. This threshold calculated in TTD, would be just over TTD90 billion - so we are about TTD40 billion beyond that.

Gross Public Sector Debt Outstanding: Trinidad & Tobago
In TTD Millions



Source: Central Bank of Trinidad and Tobago, Marla Dukharan

2. The grossly overvalued TTD and other harmful FX policies

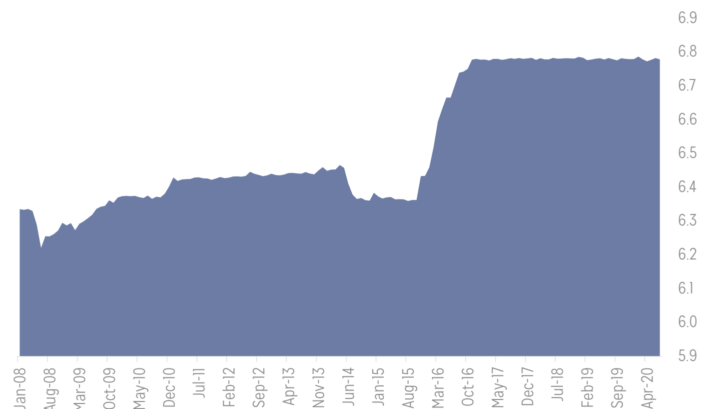
Perhaps the best indicator that the TTD is overvalued, is the existence and persistence of a black market for USD. Currently, USD are sold on average for anywhere between TTD7.50 - TTD9.00 / USD1.00, versus the official rate of TTD6.80 / USD1.00 roughly.

According to the IMF, in 2017 the TTD was as much as 42% overvalued. There has been no depreciation of the exchange rate since November 2016 - indeed, the authorities have appreciated the TTD slightly in 9 of the past 12 months, meaning that the authorities in T&T made USD cheaper to buy, just when the country is hemorrhaging USD at an average pace of USD70 million per month, as mentioned earlier. It is difficult to imagine a more perverse and harmful policy stance than this.

The overvalued TTD, in effect, subsidizes imports, making it more attractive to import than to produce domestically. It also makes our exports less competitive on global markets. Furthermore, the de facto peg to the USD means that the appreciation of the USD itself (relative to the GBP, EUR, CAD etc.) has caused a further loss in competitiveness for our goods and services to non-US trade partners. This perverse FX policy creates infinite demand for USD at the official rate, so it's no wonder that USD supply is persistently inadequate.

The overvalued currency and black market also creates an incentive for local exporters (as well as speculators) to hold on to their USD, since they would only get TTD6.78 / USD1.00 through the banking system. Longstanding tightness in the FX market also means that if an exporter converts to TTD in the banking system, when they need USD again to replace raw material or invest in equipment for example, they will face tremendous difficulty, so why bother to convert? This ultimately reduces supply. To align the exchange rate with its natural equilibrium, the Central Bank would have to allow some market determination in the exchange rate, which existed under the previous auction mechanism and worked very well, but was abolished by the previous Governor for unknown reasons.

Exchange Rate TTD : USD1: Trinidad and Tobago
USD sell rate



Source: Central Bank of Trinidad and Tobago, Marla Dukharan

Restrictions on the supply of foreign currency and an overvalued TTD are also significant disincentives to foreign direct investment, which is the other major source of foreign currency.

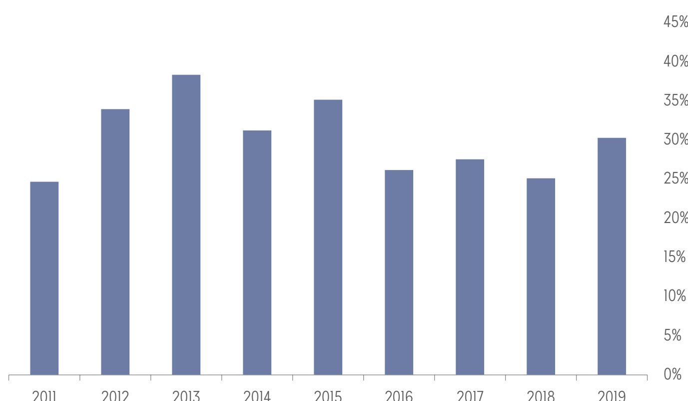
So to earn more foreign exchange, we first need clear policy objectives and institutional transparency in reporting progress against these objectives, in order to reduce uncertainty and ultimately rebuild lost confidence in the TTD.

An overvalued TTD is not sustainable, but a devaluation in and of itself is not going to solve any problems, especially not the underlying structural problems that have existed for several years. While devaluation is an 'option', it has to be part of a comprehensive reform agenda, because by itself, it will achieve little. A TTD devaluation gives the Government more fiscal revenue in TTD as it sells its energy-derived USD denominated tax revenue. But a devaluation alone may just serve to make imports more expensive, drive inflation, and by extension, drive renewed overvaluation of the currency, and it would also drive the debt-to-GDP ratio higher in TTD terms. To be meaningful, a devaluation / depreciation must be accompanied by ease of doing business reforms, fiscal reforms to balance the budget, and a private sector-led growth strategy.

3. The shrinking non-energy sector

Our non-energy exports are far insufficient to pay for what we import. On average, for the last nine years, our non-energy exports have only generated enough foreign exchange to cover 30% of our total imports.

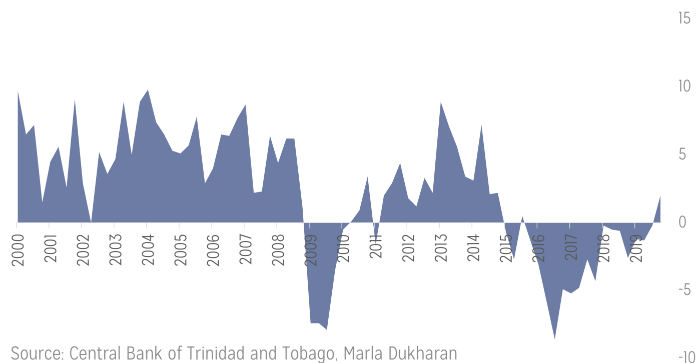
Non-Energy Exports as % of Total Imports: T&T
Percent (%)



Source: Central Bank of Trinidad and Tobago, Marla Dukharan

Non-energy exports in 2019 were down 48% versus the 2013 level. The non-energy sector has shown only two quarters of growth in the last 19 quarters, according to the Central Bank's Quarterly Economic Activity Index. There are several obstacles to the growth and development of the non-energy sector including the overvalued TTD as previously discussed, the high and rising cost and dis-ease of doing business, rising crime, weak external competitiveness, and constrained supply of USD.

Non-Energy Economic Activity Index Growth: T&T
Percent Change y/y (%) 2010=100 to Mar 2017; 2012=100 to Dec 2019



Source: Central Bank of Trinidad and Tobago, Marla Dukharan

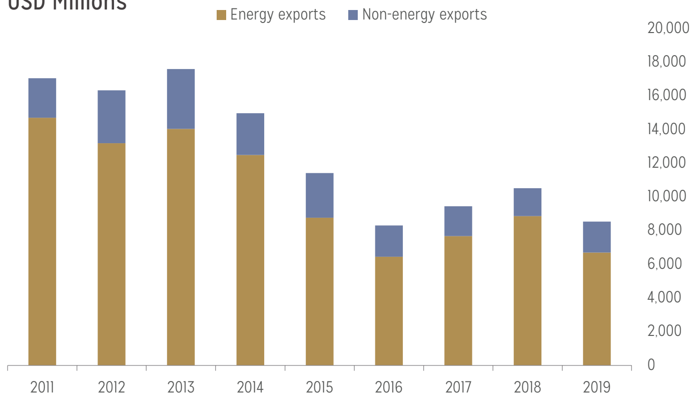
4. Energy sector weakness

Most of our foreign exchange earnings come from energy-related exports, such as crude oil, LNG, and petrochemicals such as ammonia and methanol. In essence, earnings of foreign exchange from the large and mostly foreign-owned energy sector companies is the most important way in which our country receives the majority of its foreign exchange, and we have become even more dependent on them for this purpose, based on successive administrations' shortsighted policies.

Energy exports have declined from USD14.7 billion in 2011 to below USD6.7 billion last year, meaning we exported in 2019 only 45% of the value of energy exports in 2011. Nonetheless, energy exports accounted for 78% of T&T's total export earnings in 2019.

Total Exports: T&T

USD Millions

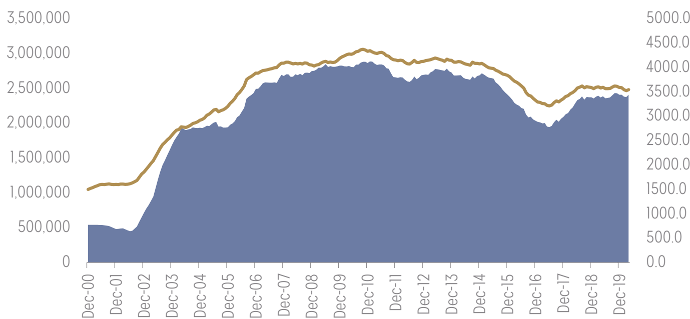


Source: Central Bank of Trinidad and Tobago, Marla Dukharan

Natural gas and LNG production have been softening. The energy sector has been struggling with price shocks and a reduction in production levels, based on reduced exploration activity, mature fields, and other disincentives, both domestic and external. Government growth targets for natural gas production, as laid out in recent budget statements, have consistently been missed. For the last 12 months, natural gas production has averaged around the same levels of mid-2006.

Natural Gas and LNG Production (Average last 12 months): Trinidad and Tobago

LNG cu m (left) / natural gas mm cf per day (right)

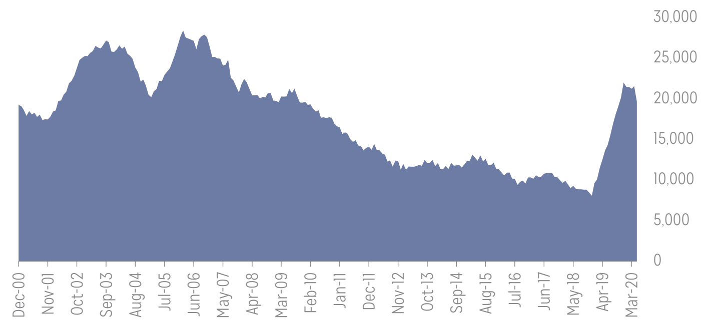


Source: Central Bank of Trinidad and Tobago, Marla Dukharan

Oil production has been on steady decline since August 2006, and we are now producing less than 40% of the all-time high. Crude oil exports, which had begun to increase after the refinery shut down, fell in May 2020 to 380 thousand barrels, the 5th lowest month on record this century.

Oil Exports (Rolling 12 months): Trinidad and Tobago

000s of barrels



Source: Central Bank of Trinidad and Tobago, Marla Dukharan

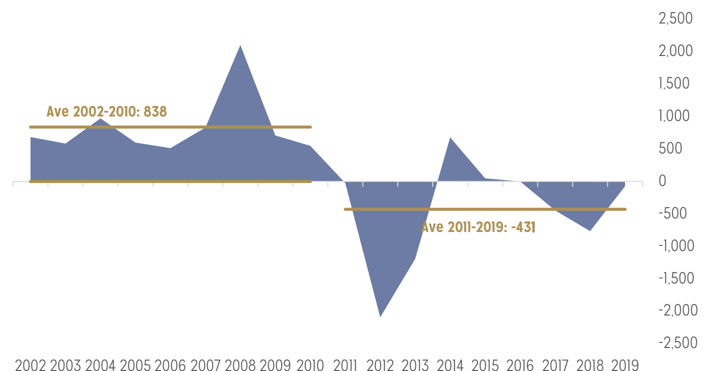
5. The net outflow of capital

Inward investment turned positive in 2019 after three years of outflows thanks to a USD261 million equity investment in financial services, according to UNCTAD. Nonetheless, Net FDI for 2019 was still negative, which has been the case in 6 of the last 9 years. This means that there was a net outward flow of investment from T&T. From 2002 to 2010, T&T averaged a net FDI of USD838 million per year, and from 2011 to 2019 has averaged a negative USD431 million per annum.

Crime, security, low productivity and high cost of doing business all contribute to the weak performance in investment. Furthermore, the weak economic environment creates an incentive for businesses and households to hold investments abroad in hard currency. Major structural reforms are necessary to renew confidence, attract new investment to T&T, and reverse losses on the capital account of the balance of payments, which drained USD2.7 billion in foreign currency in 2019.

Net Foreign Direct Investment: Trinidad & Tobago

USD Millions

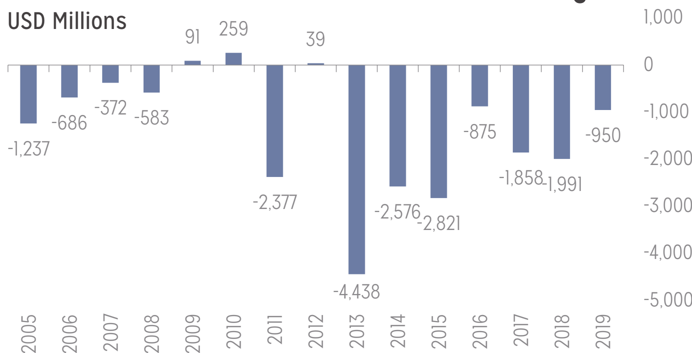


Source: UNCTAD , Marla Dukharan

6. The large and consistently negative net errors and omissions item

The Net Errors and Omissions item is the balancing item which equates the balance of payments account with the level of reserves we have. In a perfect world, the Net Errors and Omissions item would be zero, as we would be able to perfectly explain why reserves increased or declined. Net Errors & Omissions amounted to -USD17.8 billion since 2011 and over -USD20 billion since 2005. This means that there has been a net outflow of USD20 billion since 2005 that the authorities are unable to explain. Just let that sink in.

Net Errors and Omissions: Trinidad and Tobago



Source: Central Bank of Trinidad and Tobago, Marla Dukharan

There are many possible reasons why the Net Errors and Omissions Item has grown so significantly. Little is being done to address the institutional degradation that we have witnessed in the past decade at least, especially regarding the CSO. But while there are genuine statistical deficiencies, there are other factors at play. Since the earlier part of this century when FX really began to tighten in supply and become problematic, the banks were forced to import more and more physical notes to sell to customers who perhaps would not have been buying in such quantities before (higher precautionary and speculative demand) to hold and to sell on the black market. When these notes are imported by the banks, it is recorded as an inflow on the Balance of Payments, but the outflow of cash in people's pockets can't be captured. Also, money that is withdrawn in USD cash from USD bank accounts held locally can't be captured if / when they leave our shores.

Apart from the higher cash imports (and the amount that at one time the Venezuelans were lining up at our ATMs to withdraw), corruption and lack of transparency could explain high levels of capital flight in cash.

AVERTING A BALANCE OF PAYMENTS CRISIS

Fixing the fiscal deficit is probably the single most important supportive reform that would be necessary to accompany a devaluation, in order to avoid the recurrence of an overvalued currency.

Another reform, again as discussed earlier, is having a mechanism where some market determination is captured in determining the exchange rate - such as the auction mechanism in the Central Bank foreign currency injections. Beyond this, I would also suggest that an inflation-targeting regime could be looked at, in terms of the Central Bank's overarching policy regime, which would support greater overall macroeconomic stability, policy predictability and transparency, boost consumer and investor confidence, and stem the flight to quality / excess demand for foreign currency.

Switching to renewable energy generation in the medium-long term will reduce the reliance on imported refined petroleum products, and the demand for USD - supporting the devaluation and making a recurrence less likely. Fuel imports amounted to USD1.2 billion in 2019, which was ⅔ of the amount the non-energy sector generated in exports for the year.

And finally, sweeping and comprehensive ease of doing business reforms, which support private sector-led growth and job creation, would help to ensure that there is some reasonable level of local manufacturing and therefore import substitution and exports - both of which would boost export earnings and reduce the reliance on imports and foster an environment conducive to attracting foreign investment. As part of reforms, we must address issues such as corruption, bureaucracy, and crime and violence that make T&T less attractive for investment and doing business.

Most importantly, none of this can occur without a clear plan or policy agenda and associated implementation strategy to address these challenges. Though our challenges are long-standing, they are reversible if the right policy decisions are made now.

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