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April 18, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Bahamas - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with the Bahamas, which has been tentatively scheduled for discussion on Monday, May 21, 1984.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Horiguchi, ext. (5)8492.

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INTERNATIONAL MONETARY FUND

BAHAMAS

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the 1984
Article IV Consultation with the Bahamas

Approved by E. Wiesner and W.A. Beveridge

April 17, 1984

A Fund mission held the 1984 Article IV consultation discussions with representatives of the Bahamas in the period February 8-22, 1984; the Bahamas accepted the obligations of Article VIII, Sections 2, 3, and 4 in December 1973. The Bahamian representatives in the discussions included Mr. Arthur D. Hanna, Deputy Prime Minister and Minister of Finance, and Mr. William C. Allen, Governor of the Central Bank of the Bahamas. They also included senior officials from the Ministries of Finance, Tourism, Agriculture and Fisheries, Economic Affairs, Transportation, and Works and Utilities; the Central Bank of the Bahamas; the Department of Statistics; and the National Insurance Board. The staff met with officials of the public corporations and with representatives of the financial and business community. Mr. Douglas Shaw, Advisor to Mr. Joyce (Executive Director for the Bahamas), participated in the final round of policy discussions. The Fund mission consisted of Yusuke Horiguchi, Davison Budhoo, Charles Collyns, Lloyd Kenward, Fredesvinda Pham (all WHD), and Joan McLeod (Secretary-WHD).

I. Recent Economic Developments

Output in the Bahamas rose a little in 1982 after declining in 1981, and it appears that the rate of growth of the economy picked up in 1983. There was a substantial increase in the number of tourists visiting the Bahamas last year, and total tourist spending is estimated to have risen by more than 5 percent in real terms, compared with only a slight increase in 1982. Output in the relatively small, export-oriented manufacturing sector expanded moderately in 1983 following a rebound in 1982 from depressed levels. Agricultural production appears to have risen in 1983, but construction activity fell from the high levels reached in 1981-82 as several major projects were completed early in the year.

Price inflation has declined considerably in the past few years, broadly in line with developments in the United States; the 12-month rate of increase in consumer prices came down to 3 1/2 percent in December 1983 from 4 1/2 percent a year earlier and a peak of more than

12 percent in mid-1981. The limited information that is available suggests that wage developments have been less favorable. While it appears that the rate of increase in private sector wages came down in both 1982 and 1983, wages in the public sector picked up in 1983. The Water and Sewerage Corporation and the Electricity Corporation signed agreements with their respective unions in 1983 that provided for wage increases of 30 percent over a three-year period. The total wage bill of the Government rose by nearly 14 percent in 1983--which seems to imply a double digit increase in earnings per employee--compared with 9 percent in 1982.

The deficit in the current account of the balance of payments declined from $81 million in 1981 to $46 million in 1982, owing partly to a rebound of merchandise exports and to a drop in the value of oil imports. In 1983 the deficit widened to $54 million (3 1/2 percent of GDP) as the combined effect of an increase in non-oil merchandise imports and a rise in net factor payments abroad more than offset a substantial increase in net travel receipts and merchandise exports. As regards the capital account, net private long-term inflows declined substantially in 1983 for the second consecutive year, but there was a turnaround in short-term capital inflows (including errors and omissions), with a net outflow in 1982 giving way to a net inflow in 1983. Net official international reserves rose by $13 million during 1982 and by $10 million during 1983. At the end of March 1984, reserves totaled $144 million, or about two-and-a-half months of merchandise imports.

II. Economic Policies and Prospects

1. Overview

Last May, in concluding the discussion on the 1983 Article IV consultation with the Bahamas, Executive Directors noted the substantial deterioration that was occurring in the public finances and recommended that the Bahamian authorities take effective action to reverse the situation. Since then the fiscal situation has remained weak, and the need for improvement in this area continues to be the main policy issue.

The deterioration in the overall financial position of the public sector in the period 1981-83 reflected a major increase in investment spending in the face of a decline in the current surplus. To a considerable extent, the fiscal deficits in 1981-83 were financed by borrowing in the international financial markets. It appears likely that the financial position of the public sector will strengthen over the next few years as a result of a reduction in investment spending that is in prospect, but a sizable overall deficit is expected to remain.1/ At

1/ As discussed more fully in section 2, the prospect of a strengthening in the financial position of the public sector hinges on the assumption that certain investment projects that are currently at a preliminary stage of consideration will not be carried out in 1985-86.

the same time, amortization payments on the existing foreign currency debt of the public sector are scheduled to increase substantially. Unless there is a significant change in policy, there is a risk that foreign debt repayments and the remaining public sector deficits will lead to serious pressures on international reserves. Against this background, discussions with the Bahamian authorities focused on the outlook for the public finances and the fiscal adjustments that might be called for; the advisability of refinancing the largest of the existing foreign currency loans; and the policies related to interest rates and foreign investment in the Bahamas that might be pursued in order to help protect the balance of payments position.

2. The public finances

The overall balance of the public sector (which includes the Government, the public corporations, and the National Insurance Board) shifted from a surplus of $16 million in 1980 to deficits of $35 million in 1981 and $65 million (4 1/2 percent of GDP) in 1982. The public corporations--notably the Hotel Corporation, the Electricity Corporation, and the Telecommunications Corporation--undertook major investment projects in 1981-82, at the same time that the current surplus of the public sector was declining appreciably. In spite of a reduction in capital expenditures, in 1983 the overall deficit of the public sector remained virtually unchanged from 1982 as there was a further worsening in the current balance. In the past three years, and particularly in 1981 and 1982, the public sector relied heavily on foreign currency borrowing to finance its deficits. As a result, by the end of 1983 the foreign currency debt of the sector reached US$242 million (16 percent of estimated GDP), some US$140 million higher than three years earlier.

As regards the operations of the Government, the overall balance shifted from a small surplus in 1980 to deficits of about $26 million in 1982 and $33 million in 1983. At the same time, there was a surge in government loans and advances to the public corporations. As a result, the net financing requirement of the Government rose substantially in the past three years and reached $86 million (more than 5 1/2 percent of GDP) in 1983. The deterioration in the fiscal performance of the Government in 1983 is worrisome as it occurred despite favorable economic developments. For the first time in 11 years the balance on current account registered a deficit (of $16 million), owing to a large revenue shortfall and considerable expenditure overruns. Investment spending, which had been budgeted to reach nearly $60 million, had to be limited to about one fourth that level in order to keep the borrowing requirement within manageable proportions.

The budget for 1984 (presented in December of last year) aimed at a substantial improvement in the fiscal position of the Government. According to the budget, revenue would rise substantially, reflecting

measures that were proposed,1/ and the growth of current expenditures would slow markedly; as a result, the Government would register a current account surplus of $32 million. The budget provided for capital expenditures of $39 million and, on that basis, the overall deficit of the Government was projected to decline to $8 million (less than 1/2 percent of GDP) in 1984.

Based on more recent information, the staff estimated that in 1984 the current account of the Government would show a deficit of $3 million while the overall deficit would reach $42 million. Prior to the conclusion of the consultation discussions, the Bahamian authorities revised their fiscal estimates for 1984; the revised official estimates are close to those prepared by the staff. With respect to the medium term, the staff projected that, in the absence of any further action beyond the measures announced in the 1984 budget, the deficit in the overall balance of the Government would increase somewhat in the period 1985-86.

Turning to the rest of the public sector, the overall deficit of the public corporations, which had risen from $65 million in 1981 to $75 million in 1982, declined to $55 million in 1983, reflecting a considerable improvement in their operating performance. This improvement resulted from increases in electricity and water rates that were authorized by the Government in late 1982 for the first time since 1977 2/ as well as a rise in revenues from casino operations accruing to the Hotel Corporation. In 1983, capital expenditures by the public corporations remained at the high levels recorded in the previous two years. The surplus of the National Insurance Board declined from $25 million in 1982 to $23 million in 1983, owing to an increase in benefit levels that took effect in late 1982.

The combined financial position of the public corporations and the National Insurance Board is likely to strengthen markedly in the next few years as a result of a sharp reduction in investment.3/ The operating performance of the public corporations is projected to deteriorate in the period 1984-86, reflecting large increases in wage costs and a reduction in electricity rates scheduled to take place in 1984. The

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1/ These measures include increases in customs duties on cigarettes, alcoholic beverages, and petroleum products; increases in the stamp duty and the insurance premium tax; and changes in various administrative fees and charges. In the budget, it was estimated that these measures would yield $20 million in 1984.

2/ A surcharge system has allowed the Electricity Corporation to pass higher oil prices through to consumers. However, from 1977 to 1982, there was no adjustment to the Corporation's basic tariff structure to allow for increases in other costs.

3/ It should be noted that these projections do not include the B$62 million investment program of the Hotel Corporation which is currently being considered. If approved by the Government, the project would be implemented in 1985-86 and would be financed entirely by foreign currency loans.

surplus of the National Insurance Board would rise to $30 million in 1984, in the wake of an increase in the maximum taxable earnings in late 1983, but would decline thereafter owing to scheduled benefit increases.

Taken together, the staff's projections for the Government and for the rest of the public sector indicate that the overall balance of the total public sector would be in deficit by $34 million in 1984, $23 million in 1985, and $30 million in 1986. Moreover, according to the current amortization schedule, repayments of the public sector's existing foreign currency debt would amount to US$20 million in 1984, US$31 million in 1985, and US$47 million in 1986; the large increases in 1985 and 1986 reflect the start of the repayment of a US$150 million Eurodollar loan to the Government that was used to finance the Hotel Corporation's investment programs. It may be noted that if the new investment program of that Corporation were implemented in 1985-86, the overall deficit of the public sector in these two years would be substantially larger than the figures just cited.1/

The projected deficits of the public sector under the existing fiscal plan and the scheduled foreign currency debt repayments give an indication of the size of the problem that the public sector will have to deal with in the next few years in order to avoid adverse effects on official international reserves. Bahamian representatives thought that these projections were not unreasonable and agreed that they pointed to difficulties in the period ahead. They were hopeful that a continued rapid expansion of the U.S. economy would result in a strong growth of tourism and a pickup in foreign investment in the Bahamas, thereby alleviating the problem to a considerable extent. Nevertheless, they noted that if a clear need were to arise, the Government would be prepared to take vigorous action to reduce expenditures below budgeted levels and would intensify efforts to improve the efficiency of revenue collection.

The Bahamian authorities said that they were considering the advisability of refinancing the US$150 million Eurodollar loan that was used to finance the Hotel Corporation's investment programs. Officials of the Central Bank were of the view that, although it would be costly under the prevailing international financial market conditions, refinancing was almost inevitable in view of the mismatch between the short amortization period of the loan (4 1/2 years following a four-year grace period) and the normal payback period of hotel projects (20-25 years). They were concerned that the external reserves of the Central Bank were too small to withstand the pressures that would result from the repayment of the loan according to the present schedule. The staff pointed out that there were risks associated with reliance on refinancing if the difficulties related to the repayment of the loan reflected not only cash flow problems but also more fundamental problems stemming from a low rate of return on investment relative to the cost of borrowing;

1/ As the program would be financed entirely by external borrowing, its implementation would have no direct impact on the foreign exchange reserve position in 1985-86.

such problems could only be dealt with by action to improve fiscal performance. The staff also noted that an increase in the spread over LIBOR and a large front-end fee that would be involved in the refinancing operation would make it even more difficult for the Hotel Corporation's investment programs to satisfy the rate of return criterion.

To gauge the extent to which cash flow problems could be alleviated by refinancing, the staff prepared a scenario portraying the medium-term outlook on the assumption that the existing US$150 million loan would be refinanced by a new loan with 7 1/2 years maturity.1/ Under this scenario, the repayment of foreign currency debt would be reduced by US$7 million in 1985 and US$13 million a year in 1986-88. However, the public sector's overall deficit would increase by US$5 million in 1985, owing to the payment of the front-end fee and higher interest costs; furthermore, larger interest payments would increase the deficit by US$2 million in 1986, US$3 million in 1987, and US$5 million in 1988. This scenario suggests that refinancing would provide only a limited breathing space and that the public sector would still have to make sizable adjustments in the next few years.

In reviewing the outlook for the public corporations, the Bahamian officials were not optimistic that effective steps could be taken in the next few years to bring about a significant improvement in operating performance.2/ They noted that the Government had been searching for ways to restrain cost increases of these corporations, without much success so far. They referred to large wage settlements granted by some of the public corporations in 1983 as damaging to profitability. They also noted that changes in public utility rates involved politically sensitive decisions, and that for this reason it was difficult to foresee major changes in policy regarding public utility pricing in the near future. On the question of government financial assistance to public corporations, the Bahamian representatives acknowledged that there continued to be disagreements between the Government and some of these corporations concerning the terms of repayment of certain loans and a speedy resolution of these issues could not be anticipated.

1/ The new loan was assumed to be repaid in 15 installments of US$10 million each, starting in July 1985. It was also assumed that the front-end fee would be 3 percent of the value of the loan and the interest rate would be set at 1 1/2 percentage points above LIBOR (compared with 1 1/8 percentage points above LIBOR for the existing loan); LIBOR was assumed to remain at the level that was prevailing at the time of the mission (about 10 percent).

2/ It should be noted that the operating results of the public corporations as presented in Tables 12 and 13 of the recent economic developments paper do not allow for depreciation charges nor for interest charges that the Government has paid on the loans that were used to finance the investment projects of the Hotel Corporation. If these charges were included, the combined current balance of the public corporations would have been in deficit, albeit slightly, even in 1983 when, as noted earlier, there was a substantial strengthening in their operating results.

3. Monetary developments and policies

Interest rates in the Bahamas have changed relatively little in recent years and during most of the period from 1979 to the summer of 1982 they were substantially below U.S. rates. Following a gradual reduction from a peak reached in mid-1981, the differential in favor of U.S. rates disappeared during the second half of 1982 as U.S. rates declined, and in 1983 the differential was slightly in favor of Bahamian interest rates.1/

Developments in the domestic banking sector tended to reflect these movements in the interest rate differential. From 1979 to 1981 the expansion in Bahamian dollar credit to the private sector exceeded by a wide margin the rise in Bahamian dollar deposits at the commercial banks. As a result, the liquidity position of the commercial banks became increasingly strained and the banks borrowed heavily from the Central Bank. The growth of Bahamian dollar deposits picked up during 1982, but the liquidity position of the commercial banks remained tight, owing to a large increase in the demand for Bahamian dollar credit by the public corporations. During 1983 the growth of Bahamian dollar credit slowed while local currency deposits rose at a faster pace than during 1982; as the liquidity situation eased, commercial banks repaid credit from the Central Bank.

In reviewing monetary developments, officials of the Central Bank said that at present interest rates in the Bahamas were at levels that seemed appropriate in relation to U.S. rates. However, from a domestic perspective, they felt that prevailing interest rates in the Bahamas were too high. For this reason, the Central Bank would not necessarily allow Bahamian rates to rise in step in the event of a significant increase in U.S. rates. In the officials' view, a change in the interest differential of a few percentage points would not give rise to serious balance of payments pressures given the existing controls on capital flows. Nevertheless, they emphasized that the Central Bank would be prepared to adjust domestic interest rates to whatever extent needed to defend its foreign exchange position.

Central bank officials said that their determination to defend foreign exchange reserves derived from a concern that an appreciable decline in reserves would undermine confidence in the Bahamian dollar; if confidence were lost, it would be extremely difficult to maintain the parity with the U.S. dollar. They valued highly the discipline that the maintenance of a fixed exchange rate imposed on financial policies and stressed that such an exchange rate policy was appropriate in view of the Bahamas' close economic relations with the United States and the downward rigidity of real wages observed in the Bahamas. The officials noted that controls on capital flows had at times been instrumental in

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1/ The differential referred to here is in terms of prime lending rates. In terms of deposit rates, U.S. rates are a little higher than corresponding Bahamian rates.

preserving the existing exchange rate arrangements, although they acknowledged that such controls were not desirable from the standpoint of resource allocation. However, in their opinion capital controls were less harmful than wide interest rate gyrations (as would have occurred in 1980-82 in the absence of such controls) or the loss of financial discipline that might follow a departure from the present parity with the U.S. dollar.

Central bank officials expressed some skepticism about the merit of a policy of allowing interest rates to be determined fully by market forces. Referring to work conducted in the Central Bank on the interest rate elasticity of private savings which indicated a weak link between these two variables, they said that they were doubtful that interest rates would play an effective role in matching flows of savings and investment in the Bahamian economy. The staff noted that its preliminary work suggested that the savings-investment balance of the private sector was sensitive to changes in real interest rates.1/ While recognizing the limited nature of the data base, the staff conjectured that market determined interest rates would regulate income and expenditure flows in the Bahamian economy in such a way as to help maintain the external balance of payments within a sustainable range. At any rate, to the extent that the overall balance of the public sector was in deficit, the private sector had to generate net savings if an external imbalance were to be avoided; the key question was whether the price mechanism would serve to reconcile competing claims on financial and real resources more efficiently than other allocating devices.

Central bank officials noted that a main feature of credit market developments in the past two years was a marked shift in the distribution of credit toward the public sector at the expense of the private sector.2/ The private sector was a net supplier of funds to the domestic financial system in 1982 and 1983, financing indirectly a significant portion of the public sector's deficits; in contrast, in the period 1980-81 the private sector had been a net user of funds. The staff expressed concern that, while the reduction in domestic credit extended to the private sector in 1982-83 served to offset balance of payments pressures coming from increased fiscal deficits, the continuation of this trend could have serious implications for long-term economic performance, unless the public sector gave increased emphasis to economic efficiency in selecting investment projects and in managing current operations.

1/ Appendix I to the recent economic developments paper provides a statistical analysis of the relationship between the savings-investment balance of the private sector and real interest rates.

2/ Net credit extended by the domestic financial system to the public sector rose by $25 million and $42 million, respectively, in 1982 and in 1983, following a decline in each of the three preceding years. Credit to the private sector increased by $56 million in both 1982 and 1983, down from an annual average increase of nearly $70 million in the period 1979-81.

4. External policies and issues

On the policy toward private foreign capital inflows, the Deputy Prime Minister said that the basic position of the Bahamian Government was to welcome foreign direct investment. He acknowledged, however, that bureaucratic procedures needed to be streamlined in order to deal more promptly with applications for foreign investment. Moreover, he thought that government agencies needed to become more effective in seeking out potential foreign investors. The mission noted that there were indications that the policy of Bahamianization 1/ had been an impediment to foreign direct investment. The Bahamian representatives said that they did not think that this policy as such had an adverse impact on foreign investment although administrative delays in processing investment applications might have turned away some potential investors.

As mentioned earlier, the foreign currency debt of the public sector increased sharply in the past three years in connection with the investment programs of the public corporations (notably the Hotel and Electricity Corporations). In the discussion of the public external debt situation, it was noted that debt service payments had declined slightly in 1983, reflecting the fall in interest rates abroad; as a ratio to exports of goods and services, debt service payments were 4 percent in 1983, compared with 4 1/2 percent in 1982. While this ratio was expected to rise somewhat in the next few years, it would still remain relatively low by international standards. The staff noted that, because of the high import content of tourism in the Bahamas, the debt service ratio might not be a very meaningful indicator of the public sector's external debt position. Other measures provided a somewhat different reading of the situation; for example, the ratio of debt service payments to the public sector's total revenue was 8 1/4 percent in 1983, and was expected to approach 10 percent in 1986. In any event, the key consideration in assessing the public sector's external debt was that in the next few years, in the absence of concrete action, the sharp increase in amortization payments would coincide with fiscal deficits of considerable size.

The Bahamas maintains an exchange system free from restrictions on payments and transfers for current international transactions. Capital transfers are subject to exchange control approval and outflows of resident-owned capital are restricted, although the controls are applied in a flexible manner. In principle, inward investment by nonresidents is unrestricted. However, there are guidelines as regards foreign ownership of businesses. When inward investment takes the form of a purchase of real property, application must be made to the Foreign Investments Board. This Board, which comprises seven designated ministers of the

1/ This policy consists of a set of guidelines concerning the foreign ownership of businesses, the areas of business activity exclusively reserved for Bahamians, and employment and training of local personnel by businesses whose majority ownership resides with foreign investors.

Government, exercises general supervision and control over nonresident ownership of land. There is also a special market in which proceeds from certain capital transactions may be negotiated between residents through the intermediary of an investment currency dealer at freely determined rates, but the volume of transactions in this market is very small.

5. Development policies and issues

The Deputy Prime Minister said that the Government's economic development strategy was based on the notion that public sector investments with clearly defined priorities gave guidance to the private sector, which, if left alone, could not be counted upon to take a decisive role in the process of development. In his view, the public sector's involvement in strategic sectors such as tourism was indispensable, and the investment projects of the Hotel Corporation had to be seen in that light. He saw no reason at present to change the basic development strategy, although he recognized the need for a continuing review of priorities and greater emphasis on economic criteria in the selection of investment projects.

The expansion of tourism continues to be a major element of the Government's development strategy. Notwithstanding a small decline planned for 1984, the Government's budget continues to include large allocations for the Ministry of Tourism, which has been engaged in a major expansion of promotion activity. The Government is also involved in the tourism industry through the operations of the Hotel Corporation, which at present owns roughly 12 percent of the total hotel rooms in the Bahamas. As noted earlier, a new $62 million investment project of the Hotel Corporation is currently under consideration. The rate of return on these investment projects will critically influence the country's long-term growth performance as well as the public sector's fiscal position.

Officials of the Ministry of Tourism were pleased with the sharp rise in tourist arrivals in 1983 and were confident that the favorable trend would continue in 1984. It was noted, however, that the rapid increase in the number of tourist arrivals appeared to have been accompanied by a continued decline in expenditure per tourist. The officials observed that such a decline was a general feature of international tourism at the present time; tourists were taking shorter vacations and spending less per day (in real terms) than in the past. For this reason, the Ministry's promotion activity had been targeted at potential customers with high spending capacity while at the same time increased efforts had been made to upgrade hotels and other tourist related facilities. The Bahamian officials were convinced that world demand for luxury tourist resorts was large and that the Bahamas could capture a greater share of this demand by increasing its supply of first class facilities.

In reviewing the performance of the new hotel 1/ of the Hotel Corporation in the first few months of its operation, officials of the Ministry of Tourism said that occupancy rates had been kept at high levels although this result had been achieved in part through the use of substantial price discounts. Representatives of the Hotel Corporation expressed some concern that the outlook for this hotel might be somewhat less favorable than the feasibility study had suggested. The Bahamian representatives noted, however, that this project had to be seen in a broader context; they were hopeful that this project would give rise to increased tourist traffic, employment, and income, provide support to other sectors of the economy, and generate government revenue. The staff noted that there were indications that privately owned hotels had been adversely affected by the recent increase in facilities owned by the Hotel Corporation. It would seem likely that this effect would intensify if the new project of the Hotel Corporation were carried out.

III. Staff Appraisal

In 1981-82, the Bahamas was confronted with difficult economic problems stemming in part from weak external demand and high interest rates abroad. The decline in U.S. interest rates in the second half of 1982 and the strong recovery of the U.S. economy in 1983 relieved the external pressures on the Bahamian economy. As a result, activity in the tourism sector has picked up, debt servicing costs have fallen, and the liquidity problem of the banking system has been alleviated. The external environment is likely to remain relatively favorable in 1984-85, but the extent to which the Bahamian economy will benefit from these external developments will depend on the policies pursued by the Bahamian authorities.

In the view of the staff, a key policy aim at the present juncture should be a strengthening of the financial position of the public sector, which has deteriorated substantially in the past three years. Although it is possible that there will be an appreciable improvement in the fiscal position in the next few years as a result of a reduction in the public corporations' investment spending, an overall deficit of considerable size would still remain. In addition, amortization payments on the public sector's foreign currency debt are scheduled to increase sharply in 1985-86. Taken together, these prospects point to a fiscal problem of the order of 4 percent of GDP that needs to be addressed in the next few years in order to forestall the emergence of pressures on foreign exchange reserves. In the view of the staff, refinancing of the US$150 million Eurodollar loan, which may well be inevitable, would provide only a limited respite and would not alter in any significant way the conclusion that a sizable adjustment in the fiscal position will be needed in the near future. Thus, the staff would urge the authorities to start taking effective action immediately.

1/ The bulk of the US$150 million Eurodollar loan was used to finance the construction of this hotel.

As regards ways to strengthen the fiscal position, the staff takes note of the efforts that are underway on the revenue side and of the desire of the Bahamian authorities to preserve the tax haven status of the country. These considerations suggest that at present the room for additional revenue raising measures may not be large, although there does appear to be considerable room for increased efficiency in revenue collection, particularly in the areas of property and tourism taxes and import duties. In these circumstances, progress on fiscal adjustment requires that the Bahamian authorities curb the growth of government spending. In particular, the staff would emphasize the need for restraint on current expenditures--especially wages and salaries--which have grown rapidly in recent years.

A strategy aimed at improving the fiscal situation should include a careful review by the Government of the operations of the public corporations, particularly as regards their cost control mechanisms, pricing policies, and investment decisions. Recent wage settlements for some of these corporations have been very large in relation to current inflation rates. These wage developments are disquieting not only because of their adverse impact on the operating performance of these corporations, but also because they are likely to influence private sector wage behavior. The staff would urge the authorities to find ways to ensure that these corporations hold down the costs of their operations, as a means to strengthen the public finances. At the same time, the staff believes that the Government's policy on prices charged by the public utilities should become more flexible. In this regard, the staff would note that relatively high utility rates in the Bahamas are a reflection of high costs of production of utility services; shielding users from these high costs increases the burden on the economy for providing such services. Costs can only be lowered by improved efficiency, including strict restraint on wages and stringent application of economic criteria in the selection of investment projects.

As regards the capital expenditures of the public corporations, the staff takes note of the Bahamian authorities' view that the public sector, through its investment programs with clearly defined priorities, should play a leadership role in the process of economic development. In reflection of this basic strategy, the role of the public sector in the Bahamas has grown well beyond the provision of the infrastructure needed to create an environment conducive to private investment. Especially in tourism, the public sector has a substantial involvement in commercial activities and competes directly with the private sector. The extent to which such involvement enhances the long-term growth of the Bahamian economy will depend critically on the efficiency of public investment.

The centerpiece of the Government's strategy regarding tourism--as expounded by the officials of the Ministry of Tourism--is to transform the Bahamas into a luxury tourist resort with facilities for diverse activities, through extensive involvement of the public sector. Undoubtedly, the installation of luxury facilities by the Hotel Corporation, if

accompanied by a vigorous promotion campaign by the Ministry of Tourism, would attract the kind of customers being sought. However, the key question in this regard is whether the benefits derived from additional customers would be greater than the extra costs incurred. In calculating costs, the budgetary implications of the operations of the Hotel Corporation and the Ministry of Tourism should be taken into account. In light of these considerations, the Government would be well advised to exercise utmost caution in deciding on the implementation of the new investment program of the Hotel Corporation.

Prospective pressures on the balance of payments would be moderated to the extent that the private sector increases its surplus of savings over investment or that private foreign capital inflows rise. Of particular importance in this context are policies relating to interest rates and foreign direct investment in the Bahamas. On interest rate policy, the staff notes that at present the relation between domestic and foreign interest rates does not appear to pose a major problem. However, as in the past, the staff urges the Bahamian authorities to pursue a more flexible interest rate policy; such a policy would facilitate the maintenance of the existing exchange rate arrangement through its influence on the private sector's savings-investment balance and on private international capital flows. Moreover, a more flexible interest rate policy would reduce the need for reliance on capital controls and would pave the way for their removal, with favorable effects on resource allocation.

On the policy toward private foreign capital inflows, the basic position of the Bahamian Government is to welcome foreign direct investment. The staff notes, however, that bureaucratic procedures need to be streamlined. The staff also notes that the policy of Bahamianization appears to have been a factor impeding foreign direct investment in the Bahamas. In view of the difficult external balance of payments situation in which the Bahamas is likely to find itself in 1985-86, it would seem that a re-examination of the costs and benefits of this policy is in order. If the main problem in this respect is that of delays in processing investment applications--as the Bahamian authorities believe--particular attention should be given to streamlining administrative procedures in this area.

Regarding the frequency of Article IV consultation discussions, the Bahamian authorities stressed the benefit they received from such discussions and wished to maintain the present 12-month cycle.

Fund Relations with the Bahamas
(As of March 31, 1984)

I. Membership Status

(a)	Date of membership:	August 21, 1973.
(b)	Status:	Article VIII.

A. Financial Relations

II. General Department

(a)	Quota:	SDR 66.4 million.
(b)	Total Fund holdings of Bahamian dollars	SDR 55.52 million or 83.61 percent of quota.

III. SDR Department

(a)	Net cumulative allocation:	SDR 10.23 million.
(b)	Holdings:	SDR 1.05 million or 10.31 percent of net cumulative allocations.

IV. The Bahamas has not used Fund resources to date.

B. Nonfinancial Relations

V. Exchange rate: The Bahamian dollar is pegged to the U.S. dollar at B$1 per U.S. dollar. The official buying and selling rates are B$1.0025 per U.S. dollar and B$1.004 per U.S. dollar, respectively.

VI. Last Article IV consultation: The previous consultation discussions with the Bahamas took place in February 1983 and the staff report (SM/83/64, 4/20/83) was considered by the Executive Board at EBM/83/69, May 13, 1983. The Bahamas is on the standard 12-month cycle.

VII. Technical assistance: The Central Banking Department has been providing technical assistance in several areas to the Central Bank of the Bahamas: from 1976 to May 1982 experts served as the Research Advisor to the Governor; since 1978 specialists have been assigned as the Chief Accountant; for six months beginning March 1983 assistance was provided in matters relating to bank supervision; and since March 1984, a new expert has been assigned to the task of setting up and heading a Bank Supervision Department.

A specialist has been nominated by the Fiscal Affairs Department to serve in the Ministry of Finance as Advisor in the financial administration and policy fields.

VIII. Statistical data: In the following four areas, statistical data for the Bahamas are not adequate: national income accounts data are published only for the period 1973-79; employment and labor force data have not been published since 1979; comprehensive data on merchandise trade have not been published since 1977; and no comprehensive data on wages are available. In other areas, the quality and timeliness of data are considered reasonably adequate.