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Statement by Mr. Hockin and Mr. Rolle on The Bahamas
Executive Board Meeting
October 27, 2010

Our Bahamian authorities welcome the frank and constructive engagement with staff, which provides valuable input to the design and implementation of macro-economic policies. The staff's paper has appropriately focused on the important medium-term challenges facing The Bahamas. There is broad agreement with the thrust of the assessment.

The Economic Climate and Outlook

As outlined in the staff report, the effects of the global crisis were transmitted to The Bahamas through the real sector, with contractions in output during both 2008 and 2009, owing to declines in FDI and tourism receipts. The effects on the financial sector were seen in a deterioration in asset quality, and a significant rise in NPLs. In line with increased credit risks, softer demand and supply conditions and a more conservative monetary policy stance, domestic credit expansion slowed significantly, particularly during 2009 and 2010. This helped to cushion the pressures on the external reserves. The Bahamas meanwhile, benefited from reduced external price pressures, which led to a softening in the inflation rate.

On the fiscal side, budgetary shortfalls have widened, causing a notable increase in the debt-to-GDP ratio. This corresponded to weakness in revenue collection, despite tighter expenditure controls, even whilst the authorities increased social safety support and maintained priority outlays on productive public sector investments.

Given the very tentative outlook for consumer confidence within the United States, the major trading partner, tourism demand and hence the economic recovery is expected to be subdued—very mild at best in 2010 and with only modest growth over the medium-term. Already, a more aggressive promotion campaign is helping to stabilize tourism and produce some gains. However, receipts may not recover to 2007/08 levels until 2012. While the outlook should be supported by steadied FDI inflows, the authorities are taking a conservative view, given a more constrained global financing environment relative to pre-crisis conditions. Improvement in employment conditions, extending to commercial banks' asset quality is expected to trail the recovery. As a result, the uptick in credit growth is also likely to be lagged.

Within this environment, our authorities will adhere to disciplined policies, with the medium-term priority placed on fiscal consolidation, continued strengthening of financial sector supervision and regulation, solidifying the support for the currency and enhancing the economy's growth potential.

Fiscal Policy

The medium-term fiscal objective is to reduce public sector imbalances, lowering the debt burden and limiting the overall size of the public sector. In this regard, the authorities envision achieving primary surpluses, as the economic environment improves. While there is agreement that the pre-crisis debt ratios are more prudent levels at which to operate, the authorities are not yet inclined to set formal targets given the tentative nature of the recovery. However, the need for consolidation underlines ongoing efforts to strengthen public financial management and introduce greater transparency to the process.

The 2010/11 budget anticipates a trajectory of smaller overall deficits over the medium-term than the staff's projection and therefore a more upfront stabilization in the debt-to GDP ratio. In this regard, the authorities take a less conservative view of revenues than the staff. To safeguard this outcome, they are prepared to take contingency measures should the outcome deviate significantly from projections.

Efforts to curtail public expenditures are continuing on a number of fronts. In particular, a tight rein is being held on recurrent expenditure through the Ministry of Finance's oversight. As to the wage bill, rigid controls remain in place on new hiring within the public sector, with reliance on natural attrition to further contain expenses. Moreover, progress is ongoing to achieve a better targeting of social assistance. The government has also taken a firm decision to gradually reduce the budgetary support to deficit operating state owned enterprises (SOEs) over the next few years, with the first round of reductions made explicit in the 2010/11 budget.

A revised Financial Administration and Audit Act has already been passed in Parliament and is slated to come into effect in 2011. This more closely aligns financial management and budgetary practices with the IMF's code of good practices on fiscal transparency, including entrenching the practice of presenting a mid-year budget report, the use of multi-year fiscal projections in the budget, and the contextualizing of the budget within a medium-term economic framework. While institutionalizing many practices already being observed, the revamped law mandates a more comprehensive treatment of the public sector (including corporations); greater accountability of public official; imposes tighter deadlines for the production of audited government accounts and establishes internal audit units within ministries and departments.

Going forward, the authorities also see merit in the staff's recommendation for more consolidated monitoring and disclosure of the operations of non-financial public enterprises (SOEs), in the interest of enhanced public financial management and transparency. The need for greater transparency with off-balance sheet operations is also appreciated, notwithstanding the relatively minor financial impact of such transactions. It must be stressed though, that on an individual basis, all operations are already fully monitored, with all subsidies fully reflected in the budget and externally audited financial statements tabled in parliament. The privatization of SOEs is also considered vital to increasing their efficiency and competiveness. This process is being headlined by the divestment of 51 percent of the ownership in the Bahamas Telecommunications Company, on schedule to occur during the current fiscal year.

The authorities are convinced that there is still room to significantly boost revenue yields through increased administrative efficiencies, rationalization of incentives and adjustments of rates within the existing tax structure. This underlines the medium-term revenue improvement strategy, with yields in the range of 22 to 23 percent of GDP considered desirable. Efforts to strengthen compliance are intensifying across all major revenue categories. For the important real property category steps are underway to gradually align assessments with market valuations, while for business licensees, a new law will be introduced in January 2011 with a higher graduated scale of fees linked to sales revenues. The authorities are also persuaded that initiatives to promote e-government will provide benefits both in terms of improvements in the business environment and in revenue collections and compliance efforts. This initiative is benefitting from technical assistance from Singapore. Concurrently, the technical work is still on track to prepare for transition to a VAT, at the appropriate time that the political decision is taken, ensuring that the framework draws on the best international practices and experiences.

An important debt management initiative that the Central Bank of the Bahamas (CBOB) is spearheading is the introduction of a market-based auction system for the government's long-term domestic liabilities. In tandem with plans to have the debt traded on the domestic stock exchange, this initiative is expected to stimulate further development of the private sector debt market. From a budgetary perspective the cost of the debt should also decrease.

Monetary and Financial Sector Policies

The CBOB has maintained a tight rein on domestic credit growth since 2008, with the objective of avoiding unsustainable pressures on external reserves and safeguarding financial sector stability. While the Bank is legally required to maintain reserves to cover at least 50 percent of base money, the operational target has always been higher, with a current floor of 80 percent considered comfortable. As noted in the staff report, the monetary authorities will consider developing additional measures of reserves adequacy, also taking a more forward looking perspective, in order to frame an increase in the buffers over time.

For the banking sector, the scope and frequency of reporting to the CBOB has increased, both in response to heightened risks, and to sustain the modernization of supervisory standards. As of the end of 2010, the CBOB will have completed the rollout of its enhanced risk-based supervisory framework, for domestic banks and for large international banks. To support the CBOB's enhanced monitoring of asset quality, commercial banks are required to report on a monthly basis on credit arrears and NPLs, providing more detailed information on large borrowers and on exposures by economic sectors. The monitoring is also to ensure that institutions maintain adequate capital buffers against loan losses, with commercial banks encouraged to take a prospective approach to provisioning. While the average observed provisioning ratios are lower in comparison to the region, this reflects the heavy weight of non-performing mortgages in the credit portfolios. These remain over-collateralized, on average by between 20 percent to 120 percent. The significance of consumer NPLs is less apparent because commercial banks follow a very aggressive write-off policy for such delinquencies.

Priority is also being given to safeguarding capital buffers in the banking system. In November 2009, the Central Bank increased the target capital to risk-weighted assets ratio for commercial banks to 17 percent, with a trigger of 14 percent. Prior to this, triggers and targets were set on a case by case basis according to assessments of specific identified risks, although all licensee were subject to the minimum 8 percent risk-weighted standard. As the staff report reveals, the domestic banking system remains well capitalized above these levels. Meanwhile, the improvements to the stress-testing framework are ongoing, and the central bank is now in the process of sharing these templates to encourage commercials banks to strengthen their in-house analysis.

Plans are well advanced to consolidate the supervision of non-bank financial institutions. The government intends to establish the Financial Services Authority, incorporating the existing supervisory bodies for insurance, the securities industry and corporate and financial services providers. In the interim, efforts will continue to build capacity within the respective agencies and to enhance the respective supervisory frameworks. For credit unions, the legislation will be amended to transfer supervisory responsibility the Central Bank. The bank is obtaining technical assistance from the Commonwealth Secretariat to prepare for this handover.

Growth

Our authorities will continue to purse polices to enhance the economy's growth potential. Of note, with help from the IADB, the various mechanisms for providing assistance to SMEs (including lending, credit guarantees, business advisory services, and incentives) are earmarked for consolidation and streamlining into a unified framework. The government will place more emphasis on assisting business owners to develop better risk management skills, which allow SMEs to more easily attract financing from the commercial banking sector. Work is also progressing to consolidate incentives for non-SMEs under a unified legislative framework, removing discretionary elements, and providing investors with more clarity and transparency on what to expect from the system. The National Investment Act (NIA) and the Fiscal Incentives Act (FIA), giving effect to these changes, are expected to be tabled in parliament soon.

Conclusion

It is worth repeating that the Bahamian authorities take their responsibility to fiscal discipline very seriously. They are well aware that their ability to respond effectively to the global crisis benefitted from the headroom that existed to increase the debt. There is a commitment to gradually recovering this space over the medium-term. There is also consensus on the merits of enhancing buffers in support of the currency peg and more generally, boosting the economy's resilience to external shocks through greater diversification. They look forward to continued dialogue with the Fund's staff on these and other policy matters.