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Statement by Mr. Rediker and Mr. Lindquist on The Bahamas (Preliminary) Executive Board Meeting 10/102 October 27, 2010

Like other small Caribbean nations, The Bahamas experienced a sharp economic contraction as a result of the drop in tourism and foreign direct investment that accompanied the global crisis. The downturn has weakened the fiscal position and the banking system. As a result, the authorities need to implement a strong medium-term strategy to reduce the fiscal deficit to a level that will begin to lower the level of public sector debt as a share of GDP. Increased vigilance by financial sector supervisors will also be necessary to closely monitor the deterioration in banks' loan portfolios.

Fiscal Policy

The downturn has eroded the tax revenue base, which depends heavily on tourism. We concur with the staff that a sustained fiscal consolidation is necessary to stabilize and return public sector debt levels to the more prudent pre-crisis levels. At about 16 percent of GDP, tax revenues in The Bahamas are among the lowest in the region. Thus, to complement the expenditure measures being taken, we see merit in more comprehensive tax reforms with the goal of raising yields to the range of 22 to 23 percent of GDP over the medium term, as Messrs. Hockin and Rolle highlight in their statement. Should the authorities decide to implement a VAT, as is being considered, we would encourage them to discuss with the Fund the experience of other small island nations in VAT implementation and to seek technical assistance as necessary. We also join the staff in encouraging the authorities to consider contingency revenue measures should the yield from the planned efforts fall short.

Financial Sector

Despite the deterioration in banks' loan portfolios, as indicated by the rise in NPLs, capital buffers remain sufficient and the authorities' stress tests suggest that the system can withstand a further deterioration in asset quality. We commend the supervisory authorities for carrying out regular stress tests and encourage them to follow through with planned improvements to their analysis of interest, liquidity, and credit risks. We concur with the staff's recommendation to strengthen on-site inspections and monitoring, which will be important to monitor banks' loan books in an environment of weakened asset quality.

International reserves

The Bahamas' international reserve coverage ratios have increased over the last few years as a result of an external bond issuance and the SDR allocation, yet they remain low by international standards. Despite The Bahamas' track record of withstanding several external shocks without disruption to the peg, we see merit in targeting a larger reserve cushion to further guard against external shocks and safeguard the peg. We note that the staff's medium-term projection shows an annual overall balance of payments gap starting in 2012, with international reserves falling somewhat each year. In the context of the fixed exchange rate regime, what options do the authorities have to build reserve buffers? *Staff comment is welcome.*