December 8, 2010
Approval: 12/15/10

INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 10/103-3

3:45 p.m., October 27, 2010

3. The Bahamas - 2010 Article IV Consultation

Documents: SM/10/277 and Supplement 1

Staff: Leon, WHD; Roaf, SPR

Length: 21 minutes

Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	Alternate Executive Directors
	R. Ngugi (AE), Temporary
	T. Nguema-Affane (AF), Temporary
	J. Maciel (AG), Temporary
	B. Pereira (AU), Temporary
	M. Kollar (BE), Temporary
	K. Florestal (BR), Temporary
	Q. Chen (CC), Temporary
	J. Gramajo-Marroquin (CE), Temporary
	J. Rolle (CO), Temporary
	G. Leost (FF), Temporary
	A. Holler (GR), Temporary
	S. Krishnan (IN), Temporary
	L. Briamonte (IT), Temporary
	M. Makino (JA), Temporary
	M. Ghassemi (MD), Temporary
	M. Merhi (MI), Temporary
	Y. Friedmann (NE), Temporary
	L. Alfredsdottir (NO), Temporary
	A. Tolstikov (RU), Temporary
	S. Alnefaee (SA), Temporary
	H. Do (ST), Temporary
	A. Mursagulov (SZ), Temporary
	W. Lindquist (UA), Temporary
	G. Drummond (UK), Temporary

A. Zanello, Acting Secretary
D. Kovacevic, Assistant

Also Present

Secretary's Department: L. Bonato, M. Yslas. Strategy, Policy, and Review Department: J. Roaf. Western Hemisphere Department: G. Leon, M. Savastano. Senior Advisors to Executive Directors: N. Des Vignes (BR), P. Fachada (BR). Advisor to Executive Director: M. Sajkunovic (CO).

3. THE BAHAMAS—2010 ARTICLE IV CONSULTATION

Mr. Hockin and Mr. Rolle submitted the following statement:

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 and 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 licensees 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.

Mr. Lee, Mr. Di Maio, and Mr. B. Pereira submitted the following statement:

We thank staff for the well-focused report and the additional context provided by Messrs. Hockin and Rolle in their statement.

The Bahamas has been adversely affected by the global crisis since the first quarter of 2008 through the decline in tourism and foreign direct investment. With increased unemployment, and contraction in domestic activity, real GDP contracted by 4.6 percent in 2009 and there is significant uncertainty on the growth outlook for 2010. Against this background, we agree broadly with the staff's assessment and recommendations, and we limit our comments to fiscal adjustment and structural policies to lift growth and manage vulnerability.

A strong and sustained fiscal consolidation is required to stabilize and then reduce the debt-to-GDP ratio. We are therefore encouraged by the authorities' implementation of the fiscal measures in FY2010/11 budget which include improvements in tax administration and collection, strict expenditure controls, including wages, lower transfers to public enterprises, and a reform of fiscal incentives. However, given the risk of projected revenue shortfall endangering the fiscal targets, we agree with staff that earlier identification of contingent fiscal measures to ensure their timely and effective implementation are key to fiscal and debt sustainability. We also caution the authorities against over-optimism on the possible outcome of the fiscal measures.

We welcome the authorities' openness to the adoption of a value-added tax (VAT) in the future and note staff's cross-country evidence suggesting that successful implementation of VAT could yield additional revenue of about 2-3 percent of GDP. We acknowledge the benefits associated with a successful implementation of VAT and encourage the authorities to also understand the downside risks of the introduction of VAT such as a one-off inflation hike and the possibility of reduced revenue in the short term due to transitional and administrative challenges. We also encourage the authorities to consider the full range of other revenue-raising options that would provide stable income at a low cost to growth and with positive benefits for equity, including more comprehensive property taxation. To minimize the risks, we encourage staff to ensure that regional experiences from other small island states are considered and shared with the authorities to ensure VAT challenges are appropriately addressed.

We are encouraged by the authorities taking gradual steps towards the adoption of a more detailed medium-term macroeconomic and budget framework and consider this step crucial for developing an effective medium-term fiscal policy aimed at putting public debt as a share of GDP on a declining path, and towards allowing for the creation of fiscal space to help manage future external shocks. Consistent with the capacity and capability in the Bahamas, we encourage the Fund and other providers of technical assistance (TA) to provide strong support.

Although the applied minimum reserve target exceeds the minimum target stipulated by law, the authorities are willing to consider a reserve-adequacy indicator with staff input in its development. We therefore encourage staff to work collaboratively with the authorities to design and develop an adequate level of foreign reserve relevant to The Bahamas' context and to adequately cope with its external vulnerability in the future.

We support staff's call to strengthen the financial sector regulation and supervision. We consider the authorities' actions critical in ensuring that the risk of the increased non-performing loan (NPL) is contained and financial sector stability is maintained.

The Bahamas is heavily reliant on tourism and financial services, and relatively vulnerable to external shocks. In this context, we agree with staff that the focus on enhancing economic growth should focus on private sector led growth, with a particular emphasis on fiscal consolidation, would be beneficial for the economy. However, given the need for well-focused growth strategies, we would welcome further elaboration from staff on the prioritization and sequencing of these medium-term growth measures to ensure their effectiveness and efficiency.

On another issue, on timely and quality economic data, like staff, we encourage the authorities to make use of TA provided by the Fund to strengthen its government finance statistics and national accounts, to improve its economic surveillance and policy formulation capacity and capability.

With these comments we wish the authorities all the best in their endeavors.

Mr. Fachada and Ms. Florestal submitted the following statement:

We thank staff for a concise overview of the macroeconomic challenges that the Bahamas faces as it struggles to recover from the global crisis. We also thank Mr. Hockin and Mr. Rolle for their helpful buff statement. The repercussions of the country's tight link to the U.S. economy are effectively illustrated in the staff`s report and key policy issues going forward are well identified, namely: (i) fiscal and debt sustainability including the transparent subsidization of public enterprises; (ii) the regulation and supervision of the non-bank financial sector; and (iii) boosting growth. On the latter, the outlook is intimately linked not only to the recovery path of the U.S. economy but also on the authorities' success in diversifying the tourism product and client base as well in encouraging investors to move forward with some of the large projects tabled before the crisis.

Fiscal Sustainability

The authorities adopted difficult and unpopular fiscal measures at the beginning of the 2010/2011 budget cycle despite the tough economic times and the upcoming 2012 elections. Their efforts and determination have successfully staved off any further downgrading by a credit rating agency. Nonetheless, we concur with staff that the expected yield from the measures outlined in the budget communication is rather optimistic. First, because the fiscal package includes both increases of several taxes as well as reductions of some others in order to rationalize the tax system and eliminate trade distortions making it hard to anticipate a highly positive net effect in the short term. Second, because the tax increases may further depress the economy.

According to staff's estimates, to bring the public debt-to-GDP ratio back to the level of 40 percent of GDP by 2015/16, a primary surplus of 1.4 percent on average—the equivalent of an effort of 2.3 percent of GDP per year over the next 6 years—is needed. Considering that the primary fiscal balance has only been positive once (in 2005/06) during the past decade, achieving this debt-to-GDP ratio in the foreseeable horizon seems rather difficult and possibly unrealistic.

The report suggests that, in light of cross-country evidence, the adoption of a VAT could yield additional revenues of about 2-3 percent of GDP. However, it remains unclear how a VAT in the Bahamas would offset the high dependence on indirect taxes (chiefly trade taxes) as well as what are the respective roles of rigidity in the tax system and administrative efficiency in the relatively low level of tax collection.

The Bahamas Electricity Company (BEC) and other public enterprises in difficulty represent a significant drain on budget resources and improvements in their financial situation and management is crucial for a successful fiscal consolidation. In paragraph 9, the potential inflationary impact of planned increases in electricity tariffs is pointed out. It should be recalled that a partial cost recovery effort was launched this past August through the levying of a fuel surcharge to recuperate from customers a 10 percent customs duty and stamp tax on fuel imports for which the company had benefited an exemption for two years. This measure had to be repealed because of lack of advance notice. It is unclear to us if the planned tariff increases will be in addition to this surcharge or if they fit within a comprehensive reform agenda to improve the BEC's financial situation and whether these adjustments would allow the company to fully recover costs.

International Reserves

The significant increase in international reserves in 2009 came with a financial cost given that it was partially accomplished with the help of a US$300 million, 20-year international bond issue. We agree that strengthening international reserves in the Bahamas is paramount to mitigate the effects of large external shocks, support the currency peg and provide room for counter-cyclical policies, if necessary. We also welcome the government's intention to develop, with Fund staff's input, a reserve-adequacy indicator suitable for the Bahamas. However, we note that the Lipschitz, et al., threshold methodology suggested by staff leads to very ambitious reserve targets as actual gross international reserves only represent about half of the required floor. We would encourage the exploration of alternative methodologies and the adoption of one that leads to a realistic target and that is compatible with the characteristics of the Bahamian economy.

Financial Sector

The Bahamas's financial sector has withstood the crisis well and staff notes that it is recovering faster than its other Caribbean neighbors. The authorities need to be commended for the signing in such a short time span of 18 Tax-Information Exchange Agreements (TIEAs), well over the minimum that was required by the OECD to be removed from the grey list. Given that these TIEAs cover most of the economies with which the Bahamas does business and that these arrangements carry administrative and financial costs, we wonder if there are substantial marginal benefits to justify the signing of additional TIEAs, as staff refers to in paragraph 25. In the same vein, it would be opportune to examine how the financial sector in the Bahamas is coping with the United States's revised Qualified Intermediary (QI) Program.

Ms. Vongpradhip and Mr. Do submitted the following statement:

As a small open economy, the Bahamas has been negatively impacted by the global economic downturn. In 2009, GDP growth fell markedly, and the fiscal deficit rose further by 0.5 percentage points to 5.3 percent. With increased unemployment and contraction in the domestic activity, this adverse situation has posed uncertainties and downside risks to the growth outlook for 2010 and beyond. As we broadly agree with staff's overall assessment, we limit ourselves to the following comments for emphasis.

Fiscal Policy

We agree with staff in pointing out to the importance of bringing the budget position to a sustainable path in the medium term. As such, measures on the spending side would be essential, including the control of wage bill and new hiring. The success of ongoing tax reforms would also be critical to bolster and cement the foundations for a sustained fiscal consolidation.

We are encouraged to learn from Messrs. Hockin and Rolle that the revamped law mandates a more comprehensive treatment of the public sector, greater accountability of public official, imposes tighter deadlines for the production of audited government accounts and establishes internal audit units within ministries and departments. We see merits of all these measures in enhancing the fiscal discipline and improving the fiscal position in the long-run. In the same vein, we welcome the government's firm decision to gradually reduce the budgetary support to deficit operating state-owned enterprises (SOEs). In the medium term, privatization and public-private partnership of these enterprises could make a significant contribution to improve fiscal outlook and support the authorities' medium-term fiscal strategy. Going forward, the government's plan to divest 51 percent of the ownership in the Bahamas Telecommunications Company would be a step in the right direction to provide a benchmark to the other divestment/privatization processes.

Monetary Policy and Financial Sector Stability

The CBOB is commendable for maintaining a tight monetary policy with the objective of avoiding pressures on external reserves and safeguarding financial sector stability. While the Bank has been successful with the lean level of international reserve, we support the authorities' continued efforts to develop additional measures of reserves adequacy in order to frame an increase in the buffers over time.

We welcome the authorities' effort in modernizing supervision through enhanced risk-based supervisory framework and increasing prudential requirements for regulatory capital adequacy. With the government's intention to establish the Financial Services Authority for incorporating the existing major supervisory bodies, we invite staff's comments on any consideration to put the holistic supervisory function under the central bank's purview? In the meantime, we are concerned about the deterioration of NPLs, which require close supervision and prompt corrective actions. That being said, the authorities are encouraged to further strengthen their capabilities in this respect, and reinforce collaboration with others supervisors, as suggested by staff.

Structural Reforms

We take note of Bahamas's protracted and large external current account balance. Bearing this in mind, we see merits in diversifying the economy to enhance competitiveness as well as to reduce revenue volatility. Toward this end, we welcome the enhanced mechanism for providing assistances to SMEs.

Mr. Fayolle submitted the following statement:

We thank staff for a concise, yet comprehensive, clear and well-written report, as well as Messrs. Hockin and Rolle for their candid and informative buff statement.

This report gives a clear description of the impact of the international crisis on the Bahamian economy, and stresses the key challenges for the years ahead: defining a medium-term fiscal strategy in order to put public debt on a sustainable path and reducing the vulnerabilities in the financial system. We largely share the staff's appraisal and recommendations, and would like to emphasize the following points:

We wonder about the authorities' projections for fiscal revenues, which are more optimistic than staff's. Consequently, staff recommended the elaboration of a contingency plan, and we take note from Messrs. Hockin and Rolle's statement that the authorities are prepared to adopt contingency measures. Could we have more information on the contemplated measures?

The agreement on the need for a comprehensive tax reform is encouraging. While we welcome the plans for greater efficiency and rationalization of tax collection, we encourage the authorities to accelerate their efforts with a view to implement a VAT. Like staff, and based on lessons learned from the successful introduction of a VAT in several OECS countries, we believe that this measure would have a significant positive impact on fiscal revenues.

We welcome the steps towards the adoption of a medium-term fiscal framework, and, more generally, the new Financial Administration and Audit Act, which will align the budget implementation with the best international practices.

On the banking sector, the proportion of non-performing loans (relative to total loans) has more than doubled in two years, and continued to increase, albeit at a slower pace, during the first half of 2010. In addition, provisioning is lower than in other countries in the region (figure 5). This situation calls for a close monitoring, even if recent stress tests concluded that the banks could withstand a further deterioration in their loan portfolio.

Finally, we welcome the authorities' efforts on tax transparency and information exchange, in accordance with their commitment to the internationally agreed tax standard, allowing the country's exit from the OECD's "grey list." We encourage the authorities to actively engage themselves in the Global Forum's peer review process.

Mr. Rutayisire submitted the following statement:

We thank the staff for the well-written paper, and Mr. Hockin and Mr. Rolle for their informative buff statement.

The Bahamas's economy has been severely affected by the global crisis in 2009, with a significant decline in FDI and tourism-related activity. As a result, economic activity as a whole contracted by 4½ percent, unemployment increased, notably in the tourism and construction sectors and many fiscal, debt and financial sector indicators deteriorated. We welcome the positive recent developments in the first part of 2010, which have improved the archipelago's economic outlook. Nevertheless, there remain significant downside risks to the outlook, notably a slower recovery in The Bahamas's main trading partners. We note the authorities' continued commitment to reforms and welcome their agreement with staff on the need to implement policies aimed at increasing the country's resilience to shocks and making further progress towards macroeconomic stability over the medium term.

Fiscal consolidation will be important to bring public finances and debt back on a sustainable path. In that regard, we welcome the budget for 2010/11 that projects an increase in revenues through tax reforms and curtails expenditures, including wage bill and transfers to SOEs, while strengthening the social safety net. That said, we note that the authorities and staff have different revenue projections. We would like staff to elaborate further on those diverging views.

We note the steps being taken towards the adoption of a medium-term fiscal framework and the authorities' consideration of staff's recommendation to further increase transparency in the operations of public enterprises, in order to increase public financial management. We welcome the progress made in the strengthening of the fiscal policy framework, with the adoption of the revised Financial Administration and Audit Act, as indicated in Mr. Hockin and Mr. Rolle's statement. However, we note that two draft legislations on investment and fiscal incentives will be submitted to the parliament soon. We would like staff to elaborate more on these two legislations and their potential impact on the fiscal consolidation program.

On the monetary front, we commend the authorities for their prudent conduct of monetary policy, with a moderate credit growth and a reserve coverage ratio well above the statutory target. We note the agreement that the fixed exchange rate continues to provide an adequate nominal anchor for the peg. We note the authorities' interest in developing additional measures of reserves adequacy and support Fund TA in that regard.

In the financial sector, we welcome the stabilization of the banking system, which remains liquid and well capitalized. We take note of the findings that, despite a high level of NPLs, the system can withstand shocks stemming from a further deterioration in banks' loan portfolio. That said, we agree that banks' loan portfolio should continue to be closely monitored. The enhanced monitoring framework, as described in Mr. Hockin and Mr. Rolle's statement, will be helpful in that regard and in reducing risks to the banking system. We note that progress is being made in the establishment of a single supervisory body for all nonbank financial institutions, in order to strengthen the related regulatory and supervisory framework. We would like staff to indicate when this process is expected to be completed.

With these remarks, we wish the Bahamian authorities every success in their future endeavors.

Mr. Bakker and Mr. Friedmann submitted the following statement:

The Bahamas were strongly hit by the global crisis, with significant consequences to the fiscal accounts and deterioration in the banks' balance sheets. While recovery is already underway, policy makers must take corrective measures in order to restore fiscal sustainability and strengthen the financial system. We broadly agree with the staff appraisal and add the following comments for emphasis.

We welcome the ambitious fiscal consolidation efforts and note the authorities' intention to increase government revenues by 2 percentage points. The staff is less optimistic on the revenue side and projects only 1 percentage point increase in tax revenue for the fiscal year 2010-11. Given the sharp increase in the debt-to-GDP ratio in the last two years, the uncertainty regarding tax collection, and the projected 5 percentage point increase in the debt-to-GDP ratio by June 2012, we encourage the authorities to identify contingency measures in case of a further deterioration in the fiscal position.

The fact that the NPLs are concentrated in mortgages and that mortgages account for nearly half of the banks' loan portfolio is a source of concern. We note that the banking system could withstand a further rise in NPLs. However, we agree with staff that vulnerabilities in the banking sector remain, and that it is important to strengthen banking supervision by intensifying on-site inspections and closely monitoring vulnerable banks. We welcome the measures taken by the authorities to strengthen the regulatory frameworks for nonbank financial institutions. Indeed, these measures are important to mitigate vulnerabilities of the sector.

Mr. Rediker and Mr. Lindquist submitted the following statement:

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's 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? The staff's comment is welcome.

Mr. Bergo and Mrs. Alfredsdottir submitted the following statement:

We thank staff for a well-written report and Mr. Hockin and Mr. Rolle for their informative buff. We share the main conclusions of staff's assessment and will thus limit our remarks to only a few points.

The global financial crisis has hit the Bahamian economy rather adversely due to the high dependence on tourism and financial services. Consequently, GDP has fallen, unemployment risen, budget and external deficits have widened, and FDIs have shrunken. However, according to staff the medium-term outlook appears to be satisfactory, returning to a trend growth rate of about 2½ percent for 2012.

Fiscal Policy

The authorities have maintained spending in line with the budget in order to mitigate the demand shock. We note, nevertheless, that the budget balance has been in a negative territory for an extended period and this trend has been exacerbated in the downturn. This is a matter of concern and should be addressed as soon as the authorities believe that actions taken will not unduly depress demand. We also note that government debt is now projected to approach 55 percent by 2015. We note that tax reform is being initiated and improvements in tax administration are expected to improve revenue. Nevertheless, we agree with staff that additional, and bolder, measures may be necessary to improve the fiscal position

We agree with staff on the need for greater fiscal transparency, not least with respect to the SOEs. Also, we underline the importance of strengthening macroeconomic and financial statistics and, specially, government finance statistics and national accounts.

Monetary Policy

We agree that the fixed exchange rate continues to provide an adequate nominal anchor. On reserve cushion, we tend to agree with staff that an even larger reserve could help to mitigate the impact of large negative shocks. Could staff please comment on what levels of reserve they believe are appropriate? We welcome the intensified monitoring of asset quality by the CBOB and the safeguarding capital buffers in the banking system as described in the buff.

Financial Sector

The banking system appears to be normalizing but risk remains. On that front, staff especially draws attention to NPLs which have increased significantly in the downturn. We are concerned about the proportion of NPLs in private sector credit; could staff comment on the outlook and prospective developments? We agree with authorities and staff that the deterioration in the banks' loan portfolio warrants close monitoring and we strongly support increasing the intensity of on-site inspections and monitoring.

Mr. He and Ms. Chen submitted the following statement:

We thank staff for a concise report and Messrs. Hockin and Rolle for their helpful buff statement. Relying heavily on tourism and financial services, and with the tight link to the U.S. economy, the Bahamas was severely hit by the global crisis and the recovery outlook remains weak in the near term. We broadly agree with staff's assessment and would like to concentrate our comments on the fiscal and sustained growth front.

Given its high per capita income, the Bahamas's fiscal revenue is low in relation to GDP. With the estimated increase in public debt, we concur with staff on the need for strengthening fiscal consolidation and improving fiscal transparency. We welcome the authorities' medium-term target to increase the fiscal revenue to the range of 22 to 23 percent of GDP. In order to achieve such a target, the authorities aim at improving administrative efficiency, rationalizing incentives, and adjusting the tax rates, the outcome of which will be uncertain, as Mr. Fachada pointed out in his gray. The staff suggests introducing the value-added tax (VAT) which could result in additional revenue of 2-3 percent of GDP based on international experience. We welcome the authorities' openness to the adoption of the VAT and encourage the Fund to provide TA in this regard, if necessary.

Given the uncertainties of the global economic recovery and marked downside risks in the Bahamas economic outlook, we join staff in encouraging the authorities to make available contingent measures to avoid further decline of the fiscal revenue.

A well-structured medium-term fiscal framework will help anchor expectations and inform the policy debate. As Mr. Hockin explained in the buff statement, the revised Financial Administration and Audit Act will take effect in 2011 and provide the legal foundation for the establishment of a medium-term fiscal framework. Could staff provide comments on this act?

As a small and open economy, the Bahamas has made progress in diversifying the economy and improving the business environment. We encourage the authorities to continue to enhance its growth potential and welcome efforts to consolidate the framework for assistance to SMEs and hope the National Investment Act and the Fiscal Incentives Act will help to enhance transparency and boost private-led growth.

Mr. Mursagulov made the following statement:

We broadly share the staff's appraisal on The Bahamas's economic development policies and support the recommendations. I will be limiting myself to the following comments.

Consecutively rising fiscal balances, the steep acceleration of central government debt, and debt from public enterprises indicate a clear necessity for a comprehensive fiscal policy reform strategy to ensure the sustainability of public finances. We take note of the new tax measures and the improvements in revenue administration and collection. However, we concur with the staff that the authorities' scenario regarding the expected use of this measure is overoptimistic. Hence, we strongly support additional revenue-enhancing measures, including the introduction of a VAT.

In light of mounting debt from public enterprises, we encourage the authorities to prepare consolidated accounts for the overall nonfinancial public sector by incorporating off-budget operations in the central government budget. We would like to hear the staff's comments on the off-budget finance measures, in particular the ones through the National Insurance Board.

Even though capital adequacy and liquidity ratios are high enough for most commercial banks, we support the staff's arguments that rising NPL ratios and the deterioration of banks' loan portfolios is a warning signal that calls for intensive monitoring and supervision. Similarly, we agree with the staff that improving the international reserve position would provide a cushion to help mitigate the impact of large negative shocks and enhance the credibility of the peg.

The staff representative of the Western Hemisphere Department (Mr. Leon), in response to questions and comments from Executive Directors, made the following statement:

> I will address questions posed by Directors on fiscal consolidation, reserves, financial sector policy, and growth.
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> Beginning with fiscal consolidation, Directors noted that the authorities and the staff have different revenue projections and requested further elaboration on the divergence. While the staff fully supports the authorities' commitment to fiscal consolidation and welcomes the measures adopted by the authorities so far, our less optimistic revenue projections are based, consistent with our macro framework, on lower assumed rates of growth in revenues from international trade taxes, adjustments to dividend receipts from privatization and one-off inflows, and a general caution that receipts from enhancements to tax administration and collection may take longer to materialize.
>
> The staff, however, strongly supports the authorities' efforts to reform the fiscal incentives regime. The authorities see the need to review incentives in a cost-benefit framework that limits the period of benefits and is adequately monitored and incorporated in the budget. With estimates of incentives granted in fiscal 2009/10 in the range of 2-3 percent of GDP, the staff views that reform as having significant potential for improving the fiscal outlook. The National Investment Act and the Fiscal Incentives Act are both expected to address this reform effort.
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> Directors recommended that the staff share with the authorities the experience of other small island states that introduced the VAT to ensure that the challenges were properly addressed. As has occurred in other Caribbean jurisdictions, the staff stands ready to provide the technical assistance needed to facilitate the implementation of a VAT. Our assessment on the VAT is based on potential benefits from broadening the tax base as well as increased compliance.
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> On the expenditure side, in addition to containing recurrent costs on goods and services, the authorities' medium-term goal is to ensure that all deficit-operating public enterprises have self-sustaining financial positions, thereby limiting the need for transfers.
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> Regarding a question on the tariff charged by the Bahamas Electric Company, the staff would like to clarify that the fuel surcharge is separate

from the planned tariff increase. Our understanding is that the authorities are close to finalizing the terms of an agreement that will result in the privatization of the Bahamas Telecommunications Company.

With respect to the contingency measures to be implemented in the event of a deviation from the fiscal targets, the authorities noted that they were working on this but were not in a position to provide specific details to the staff at that time. However, the authorities stressed that they were committed to a midyear performance review in February 2011 and to adopting stronger measures in the case there is a deviation from the targets. On the measures that the authorities would favor, the staff thinks that they would be a combination of expenditure restraint and a more aggressive approach to tax administration.

On the legislative reform agenda, the staff welcomes the main goals of the revised Financial Administration and Audit Act. The staff would be happy to provide further details bilaterally to Directors. In short, the act includes measures of accountability and reporting to the parliament, some degree of integration with the macro projections for three years, statements on contingent liabilities, and a process of internal audit by the Ministry of Finance.

On the international reserves, the staff is of the view that The Bahamas has so far fared well despite its relatively low level of reserves, but a gradual strengthening of the reserve buffer would be advisable. The authorities expressed strong interest in examining a range of indicators appropriate to the Bahamian context, including indicators of reserve adequacy that could enhance the monitoring of their reserve targets. The staff looks forward to collaborating with the authorities in formulating alternative reserve adequacy indicators.

As to the authorities' options on strengthening reserve buffers, a recovery of growth and labor markets in the United States would lead to a recovery of tourism in The Bahamas, a pick-up in FDI, and an improvement in the overall balance of payments. However, the staff believes that the medium-term fiscal consolidation effort should be the key strategy for improving the overall reserve position and external stability in the country.

Directors also asked whether the staff would favor consolidating all supervision of financial services under the central bank's authority. The staff does not have a particular institutional arrangement that it favors, as long as the regulatory and supervisory framework allows for an effective supervision of the financial system, including consolidated supervision. The authorities have indicated that legislation to upgrade and consolidate nonbank supervision will be submitted to parliament in late 2010 or early 2011.

Regarding the nonperforming loan (NPL) ratios, these loans are highly concentrated in commercial and personal loans, including mortgages, which may continue to rise even in a low growth scenario. Furthermore, the reversal in the direction of the NPL ratio will almost certainly lag the recovery in economic activity. At the same time, while NPLs on mortgages are collateralized, as explained in the buff, the value of the properties has decreased and, hence, the value of the collateral decreased as well. There is no thriving secondary market for real estate sales, which is a limiting factor in off-loading certain properties by the banks.

The authorities' stress tests, however, suggest that the banking system could withstand significant further increases in NPLs while remaining above the regulatory capital threshold. The staff's view is that a holistic approach of monitoring capital adequacy and liquidity, as well as forward-looking provisions, including for losses and unforeseen problems, is a necessary condition for monitoring systemic stability.

Finally, with regard to growth, steady growth is the key to medium-term prosperity. While fiscal consolidation and a more transparent and temporary fiscal incentives regime would contribute to strengthening growth, the staff is of the view is that up-front measures to facilitate access to reliable and low cost energy, and the development of social and physical infrastructure to support both services and exports, could play a key role in promoting growth.

Mr. Rolle made the following concluding statement:

Understandably, Directors have focused in their comments on the importance of fiscal sustainability and on the weakened state of the banking sector. In this regard, we take note of Directors' calls for a stronger fiscal effort and for enhanced financial sector supervision. These are both factors motivating accelerated reforms to the policy frameworks in The Bahamas.

While on the fiscal side the authorities continue to focus on improving the expenditure management process and on measures to boost yields within the existing revenue structure, they appreciate that gains can come from a shift to a VAT. There are institutional weaknesses that need to be tackled irrespective of the structure and which, with concerted efforts, can significantly enhance revenue yields. For the most part, the timing of a shift to the VAT is only a political decision at this time. CARTAC and the Fund have been extensively involved in previous technical studies on such a shift. Nevertheless, continued technical engagement with the Fund on this topic is welcomed, particularly to draw more lessons from international experiences and to ensure that best practices are observed during any fundamental changes to the tax system.

The elevated level of NPLs in the banking system is a pressing concern for the central bank. Recent improvements in the supervisory framework have enhanced the authorities' monitoring of the situation, providing greater comfort in the accuracy of the data that is being collected, as well as in the ability of the banking system, from a capital adequacy perspective, to withstand a current setback.

In terms of oversight, the central bank began special-focus credit examinations of all commercial banks in 2009. These examinations focused on credit initiation, approval, collateral perfection, and delinquency management. The Bank followed up in 2010 with further special-focus examinations zeroing in on delinquency management.

The special-focus exams have also been introduced at the branch level to ensure there is a consistency in practices throughout the operations of each commercial bank. The authorities are monitoring these areas very closely, not only during the examination but also during quarterly credit meetings held with commercial banks. I want to assure Directors that in terms of the provisioning policies for NPLs, the Bank is indeed encouraging commercial banks to take a very forward-looking perspective in provisioning through the cycle.

In concluding, we note that while the immediate policy objective is to maintain a stable economic environment, given the very fragile recovery, the medium-term focus for The Bahamas continues to be on enhancing the prospects for economic growth, reducing the debt burden, shoring up support for the currency, and strengthening the level of supervision and regulation throughout the financial system. The authorities are firmly committed to making progress in these areas.

On behalf of my authorities, I would like to thank Mr. Leon and his team for a very constructive and cordial mission. As we have said, in relation to other countries in this constituency, our officials derive tremendous benefits from these engagements, which go beyond fulfilling their Article IV obligations. My authorities hope that they will continue to enjoy some continuity in the composition of the mission team, given the near-term policy challenges.

The Acting Chair (Mr. Portugal) made the following summing up:

Executive Directors agreed with the thrust of the staff appraisal. They noted that a sharp contraction in domestic activity amidst the global downturn has weakened the fiscal position and banks' balance sheets. Prudent macroeconomic policies have now laid the foundations of a recovery, but the outlook remains exposed to downside risks. In order to boost economic prospects, Directors encouraged the authorities to build adequate buffers against external shocks and address vulnerabilities in the fiscal domain and in the financial sector.

Directors commended the authorities for their commitment to medium-term fiscal adjustment and their strategy to reverse the recent rise in the public debt-to-GDP ratio. They welcomed the revenue and spending measures adopted in the budget, but considered that contingency measures might be needed to achieve the desired reduction in the fiscal deficit. Directors noted that broader reforms to the tax system and public finance management would also be needed over the medium term to sustain improvements in the fiscal position.

Directors considered that the longstanding peg to the U.S. dollar has provided an appropriate nominal anchor and served the country well. They took note of the staff's assessment that the current level of the exchange rate is broadly in line with long-term fundamentals. To ensure that the peg remains adequately supported, Directors encouraged the authorities to build up foreign exchange reserves over time as needed.

Directors commended the authorities' efforts to strengthen the financial system and their close cooperation with supervisors in other jurisdictions. They welcomed recent enhancements in the oversight of the financial sector and in the legal framework for security markets. Directors considered that rising non-performing loans at banks remain a concern, and that close monitoring is warranted. They also encouraged the authorities to continue strengthening the prudential framework of nonbank institutions.

Directors agreed that far-reaching structural reforms are necessary to lift medium-term growth prospects. They welcomed the authorities' plans to improve business conditions, including for small and medium-sized enterprises, and to strengthen public infrastructure in a manner consistent with the fiscal consolidation strategy.

The next Article IV consultation with The Bahamas is expected to be held on the standard 12-month cycle.

APPROVAL: December 15, 2010

SIDDHARTH TIWARI
Secretary