RESTRUCTURING THE BAHAMIAN ECONOMY

FOR THE 21ST CENTURY

Alvin Rabushka
Senior Fellow
Hoover Institution
Stanford University

Speech Delivered to the Ernst & Young Bahamas Business Outlook '97
Monday, January 6, 1997
Nassau Marriott & Crystal Palace Casino

RESTRUCTURING THE BAHAMIAN ECONOMY FOR THE 21ST CENTURY

Ladies and Gentlemen,

Since January 1995, I have enjoyed the opportunity to serve as an economic adviser to the Securities Market Task Force, which consists of an exceptional group of professionals chaired by Larry Gibson, that shares a common vision of a successful international and domestic securities exchange in The Bahamas. During the course of my research, I have met with more than a hundred distinguished Bahamians from all walks of economic, political, and social life, many of whom are in attendance at today's seminar. I want to take this moment to thank all those Bahamians who took the time to share with me their insights, experience, and knowledge about the Bahamian economy. My views on the problems and prospects of the Bahamian economy as it approaches the 21st century rest, in part, on the education they provided me.

The Bahamian economy is dependent on two sectors, tourism and financial services, both of which earn their living in foreign currencies. Although The Bahamas is an independent country, its people depend for their livelihood on the sale of services to foreigners. The proceeds of foreign currency earnings provide the means to import goods and services not produced in The Bahamas. This is the fundamental economic reality of the islands.

In both sectors, 1996 was a very good year and 1997 promises to be even better. Nonetheless, The Bahamas remains overly dependent on two sectors. If either turns down in a significant way, the current prosperity and future prospects of The Bahamas will be put at risk.

Restructuring the Bahamian economy for the 21st century means finding new sources of income and employment. This objective has always been a goal of Bahamian policy, but has yet to be realized. The technological progress affecting 21st century economic life means that the government and the people of The Bahamas must adapt to the realities of the global marketplace. Like it or not, The Bahamas will have to take all necessary steps to insure that the islands remain a user-friendly place to tourists and businessmen alike. The islands face tough competition from other tourist destinations and offshore centers, which means that

The Bahamas will have to work hard just to stay even. Staying even and getting ahead requires exploring some fundamental changes in economic policy, which is the subject of my talk.

The Historical Legacy

In my remarks today, I want to focus on two important institutions of the Bahamian economy, the public finances and the monetary system, and the interaction between them. To understand the current situation, it is necessary to set the historical backdrop.

First, the public finances. All British colonies, including The Bahamas, were subject to the colonial regulations, which included a section on the conduct of the public finances. The underlying principle of the regulations was that colonies should never subject the United Kingdom Treasury to any charges: self-support was the guiding principle. The Colonial Office had to approve the annual budget estimates, and could disallow proposed items of expenditure (though it rarely did so). In short, colonies were expected to balance their budgets.

When The Bahamas proclaimed its independence in 1973, the country was virtually free from public debt.

Second, the monetary system. Currency boards were the monetary arrangement of choice in most British colonies, and The Bahamas was no exception. A currency board is a monetary system that maintains a fixed exchange rate and full convertibility between domestic notes and coins and some reserve currency. A currency board achieves its purpose by holding 100 percent external reserves against the domestic note issue.

A currency board does not have discretionary control over the domestic money supply. Under the currency board monetary system, surpluses or deficits in the balance of payments, in the current and capital accounts, translate into increases or decreases in the domestic money supply. This arrangement is similar to the classical gold standard, balance-of-payments monetary system.

It is important to understand what a currency board cannot do. It cannot create inflation because it does not control the ultimate reserves of the monetary system. It may transmit inflation from the reserve country, but cannot create inflation because it cannot independently increase its monetary base.

A currency board cannot finance spending by the domestic government or domestic state enterprises because it is not allowed to lend to them. A typical currency board is not a lender of last resort. It does not lend to commercial banks or to other enterprises to help them avoid bankruptcy.

Ambassador Timothy Baswell Donaldson, who served during the transition from the Board of Commissioners of Currency prior to 1968, to the Bahamas Monetary Authority in 1968, to the Central Bank of the Bahamas in 1974 can fill you in on the specific details of the former Bahamian currency board. The important points, for the purpose of my discussion, is that the newly-established Central Bank of The Bahamas was empowered to buy government debt and also serve as lender of last resort to the commercial banks, which effectively enables them to buy government debt without risk.

During the currency board era, no control was placed on foreign exchange transactions inside the sterling bloc, until the United Kingdom disbanded the bloc when it floated sterling in July 1972. After that date, sterling also became a foreign currency in The Bahamas. At that moment, the Bahamas Monetary Authority, and then its successor, the Central Bank, assumed responsibility for exchange control between the Bahamian dollar and foreign currencies.

The newly independent Bahamas could have reestablished a currency board monetary system, using U.S. dollars as its reserve currency. It did not. Instead, the government established a Central Bank. This act, which was common to almost all newly-independent nations, set The Bahamas in a new fiscal direction.

The advent of internal self rule and the establishment of the Central Bank in place of the former currency board eliminated the balanced-budget requirement embedded in the colonial regulations and permitted the Bahamian government to sell public debt to the Central Bank. The government also sold public debt to the commercial banks, which is indirectly guaranteed by the Central Bank. Later, the National Insurance Board was established. Financed by a payroll tax, it, too, bought government debt, which today constitutes almost all of its assets (although these assets are government liabilities collateralized only by the power to tax). To summarize, independence brought fundamental institutional change to the conduct of government business: The Bahamian Government was now free to spend beyond its means, and make up the difference through public borrowing.

To be fair, the newly-independent Bahamas faced a backlog of unmet social needs, ranging from education to housing, health care, and infrastructure. It would have been politically difficult, if not impossible, to ask Bahamians to wait a generation for an expansion in these public programs.

The Current Situation

Let me now turn to the present day. The future development of The Bahamas is threatened with two realities that have unfolded since 1973. The first is the accumulation of a massive public debt that continues to rise year-in and year-out. The second, related to the first, is the existence of an exchange control regime that puts The Bahamas at a competitive disadvantage with such rivals as Bermuda, the Cayman Islands, the Channel Islands, Cyprus, and others. The existence of exchange control, which will remain in place for some time as I explain shortly, may be an impediment to the full development potential of the soon to be established Bahamas Stock Exchange, which constitutes an important addition to the islands' offshore sector.

First, the public finances. The Bahamas can pride itself on being a "low-tax" country. Nonetheless, the public finances have undergone steady deterioration during the past two decades in two respects. First, the relative size of the public sector, that is, all expenditures financed from public funds, has increased from less than 15 percent of the gross domestic product (GDP) to just over 20 percent of GDP. Second, the public debt of the country has steadily increased. The balanced-budget norm inherited from the colonial era eroded in marked fashion in the 1980s, as the government incurred deficits on recurrent expenditure in 1983, 1984, 1985, 1988, 1990, and every year during the 1990s. When capital outlays, which are a more important source of recent public debt, are added in, the deficits take on an even larger dimension.

During the 1980s, which enjoyed three surplus years, total deficits on recurrent expenditure amounted to $185 million. The total deficit for 1991, including capital outlays, was about $114 million; in 1992, $80 million; in 1993;

about $87 million. The changeover in the fiscal year witnessed a deficit of $49 million in 1993/94, $23.5 million in 1994/95, an estimated $84.2 million in 1995/96, and an estimated $99.1 million for 1996/97. By the middle of 1996, total national debt amounted to $1.2 billion, with additional contingent liabilities for the public corporations of $316 million, for a total national debt of $1.52 billion. This figure represents about 40 percent of the GDP.

The consequence of rising debt is an increase in debt servicing, standing at an estimated $89 million in the 1996/97 budget, or almost one-eighth of government spending. Along with wages and salaries of $353 million, these two items eat up 58 percent of the budget.

The annual budget presents deficit figures in GFS terms, which has the purely accounting effect of reducing the deficit as a percentage of GDP. This approach is misleading in that it is the total public debt, not the GFS budget deficit in any given year, which determines the cost to the community in debt service. A GFS deficit of zero would still constitute an increase in the total public debt and thereby add to the nominal fiscal burden of debt service.

A few words of the composition of public revenues are in order. The Bahamas is disproportionately dependent on one source of revenue, namely, import duties. Other important sources of revenue include stamp taxes, departure fees, property taxes, selective services, and motor vehicle taxes. Fines, forfeits, and administrative fees supply the majority of non-tax revenue. Income from public corporations is negligible, which means that these public enterprises are not being run on a commercial basis.

The Monetary System and Exchange Control

I now want to shift to the topics of the current monetary system and the sensitive subject of exchange control. The Bahamas is an Article VIII member of the International Monetary Fund, which requires that no restrictions be placed on current account transactions, unless the balance of payments is in jeopardy. Exchange control, however, applies to capital account transactions (e.g., loans, equity investments, and inward and outward direct foreign investment).

The Bahamas issues its own independent currency, the Bahamian dollar, which is set at parity with the U.S. dollar. The Central Bank maintains parity by a combination of external reserves in the form of U.S. dollars and a system of exchange control. External reserves average at last two months worth of imports. One benefit of an independent currency is that The Bahamas earns seigniorage on its note issue because it receives interest on its foreign currency holdings.

But a crucial point must be kept in mind. The issue of local currency does not mask the reality that the economy of the islands effectively rests on U.S. dollar earnings from tourism and financial services. To put this in technical language, high-powered base money in The Bahamas is not Bahamian notes and coins in circulation, but is U.S. dollar reserves of the Central Bank. Any marked decline in U.S. dollar earnings in the islands would generate a massive deflation, unless the currency were devalued, and a decline in the Bahamian standard of living. In practical terms, a decline in U.S. dollar reserves prompts the Central Bank to advise the commercial banks to tighten credit.

The Bahamas does not have a typical central bank because discretion in monetary policy is restricted by the Bank's determination to maintain a fixed rate of exchange at parity with the U.S. dollar. The Central Bank must maintain a sufficient level of foreign reserves to meet foreign dollar liabilities on current account transactions. So long as reserves are adequate, this objective can be met in the conduct of normal business. However, any diminution in foreign reserves reduces the ability of those holding Bahamian dollars to acquire foreign currency to pay overseas bills, thereby shrinking the demand for Bahamian dollars and domestic economic activity conducted in Bahamian currency.

A description of the money supply and the composition of domestic credit is required to fully understand why the Central Bank maintains exchange control on capital account transactions. External reserves of The Bahamas fluctuate around the $200 million level. On this base, the country's banks have built a domestic credit structure amounting to almost $2.6 billion as of June 1996. The ratio of M_3, the most comprehensive measure of money supply, to foreign reserves is about 13:1, which is a reasonable multiplier of money supply to base money in countries with sophisticated credit structures. (In Russia, for example, the ratio just barely exceeds 2:1.)

Domestic credit consists of loans to the government, commercial bank credit, and credit granted by other local financial institutions. In June 1996, net domestic credit to the government stood at $394 million. Of this the Central Bank provided $98 million; commercial banks and other financial institutions, $296 million. Domestic credit to public corporations amounted to $86 million. Domestic credit to the private sector came to about $2.1 billion.

The government's share, including public corporations, of domestic credit is about 18.5 percent. But this figure grossly understates the exposure of the country's credit structure to the burden of public debt. The national debt of the government consists of $1.2 billion in direct charges and another $316 million in contingent liabilities. The overwhelming bulk of these liabilities, all but some $60 million, is denominated in Bahamian dollars.

The keystone of The Bahamas monetary base, some US$200 million or so in foreign reserves, must support a total domestic money supply of about B$2.6 billion, and also support total direct national debt of $1.2 billion, of which only $478 million appears in the June 1996 money supply statistics. In the absence of exchange control, any rush to convert domestic financial assets into U.S. dollars would quickly exhaust foreign reserves, unless the commercial banks raised interest rates sharply (which would contract the economy), or undertook massive borrowing abroad from their home offices. In addition to the huge government debt, private pension funds in The Bahamas, which hold Bahamian-dollar denominated assets at over $400 million, could also exhaust all foreign reserves if they shifted, say, half of their portfolios from bank deposits and local equities to foreign equities and bonds. Insurance companies, too, hold several hundred million dollars of Bahamian assets. Market capitalization of local equities exceeds $400 million, again in Bahamian dollars.

To repeat, the entire structure of Bahamian dollar financial instruments, and the ultimate value of real domestic assets, rests on a precariously small foundation of U.S. dollar reserves, which are essential to pay import bills. The reserves are too small to both pay import bills and accommodate large-scale conversion of Bahamian assets into foreign currency. This condition explains the need for capital account exchange control.

To summarize at this point, without getting into an analysis of the merits of what budget deficits were used to finance during the past fifteen years, the conversion of the Bahamas currency board into a central bank was a major contributing factor to the government's accumulation of public debt and the practice of annual deficits on a consolidated budget basis.

The Public Finances in Conflict With the Monetary System (Or, The Government Versus the Central Bank)

A key problem with the revenue structure is that any decline in imports puts enormous pressure on the public finances. But there is another reason why heavy dependence on imports is undesirable as the most important source of tax revenue and why the tax system of The Bahamas needs rethinking.

The country's revenue system is in conflict with its system of exchange control. Rising imports generate higher revenues, which are required to meet public expenditures. But rising imports also drain foreign currency. The Central Bank maintains a watchful eye on the level of foreign reserves to insure the US$1 = B$1 exchange rate. Thus, the possibility of higher revenues from import duties conflicts with the Central Bank's exchange-rate policy of maintaining parity. If reserves decline too far, decisions must be taken to slow imports (e.g., raise domestic interest rates). The Central Bank issued such a warning in autumn 1995 when foreign reserves declined to worrisome levels.

Thus, maintaining parity between the Bahamian and U.S. dollars may compel a reduction in imports, which consequently reduces the chief source of state revenue. There is no corresponding mechanism to compel a reduction in state expenditure. In fact, there may be pressure to increase expenditure, because falling import duties reflect a slowdown in economic activity. This is a Catch-22 situation, ending in a larger public debt.

The tension between increasing state revenues through higher imports (to balance the state budget) and protecting the parity of the Bahamian dollar by maintaining adequate reserves is manageable, and has been successfully managed over time. Nonetheless, this unique combination of import duties and exchange control acts as a brake on the free flow of goods, services, and investment capital.

Devaluation of the Bahamian dollar would not improve circumstances and would, in fact, make matters worse. It would erode the value of domestic assets, generate a sharp rise in domestic prices as imports became more expensive, and send a signal to the world that the government was not prepared to get its fiscal house in order.

We might note, at this point, the disappointing performance of the officially recorded Bahamian economy in recent years. Between 1986 and the current fiscal year, total growth amounted to just over 13 percent--the two recession years of 1991-1992 wiped out much of the economy's performance during the twelve years in question. Indeed, population growth of about 2 percent a year means that per capita income actually fell over this period. (By way of historical comparison, it is estimated that per capita income rose at an annual rate of 6 percent during the 1960s.)

Where Does The Bahamas Go From Here to the 21st Century?

The Bahamas has been digging itself into a hole of public debt from which it should climb out. No problem of this magnitude, which has taken two decades to create, can be corrected overnight. Nor is it necessary to correct the problem overnight. What is required, however, is a clear statement of policy and the political determination to embark on a course that will position The Bahamas to participate fully in the global economy of the 21st century.

The first obvious step is to get to a balanced budget as quickly as possible. The government must not spend more than it takes in. The benefits of a balanced budget are several. It tells the rest of the world and the local business community that the government is serious about its fiscal responsibilities. It means that the burden of the national debt in terms of interest outlays will gradually decline over time as economic growth transforms the public debt into a steadily smaller share of the GDP. It also means that resources now drained from private hands will be available to individuals and enterprises for investment in the economy, rather than being used to finance public consumption.

A collateral step is to use the proceeds of partial or complete privatization of the public corporations, in particular, the electricity and telecommunications enterprises, to pay down public debt. In fact, I would recommend that the Parliament enact legislation stipulating this use of any funds realized from their sale. The immediate benefit would be a reduction in interest outlays. Any reduction in debt servicing costs gives room for tax reform and reduction, and frees up funds for infrastructure and other critical public requirements. The global marketplace, on line in cyberspace, would immediately notice this improvement in the public balance sheet of The Bahamas.

A third step is to rethink the revenue structure of The Bahamas to reduce, where possible, the innate conflict between reliance on import duties and the Central Bank's policy of maintaining parity with the U.S. dollar. There have been commissions in past years which have examined the very sensitive issue of tax reform in the "tax haven" of The Bahamas. I do not want to make any specific tax reform recommendations today, other than to suggest that a public dialogue should begin on this critical subject.

A fourth area of policy is for the Central Bank, in conjunction with the government, to draw up ideas to increase the foreign currency reserves on which the credit structure of The Bahamas now hinges. If reserves could be doubled, say, to $400 million, it would give the Central Bank much greater latitude in moving to a more relaxed regime of exchange control on the capital account, with an ultimate goal of possible elimination. This would help The Bahamas in its rivalry with such competitors as Bermuda and the Cayman Islands.

To that end, making The Bahamas attractive for inward direct foreign investment should become a top priority of the government. The Bahamas has done a good job in securing better ownership and management of its major hotels. The government has also met with success in attracting a large investment in Grand Bahama.

A final recommendation is to aggressively pursue diversification, especially in the offshore sector. The Bahamas can learn from other offshore centers that have gone beyond financial services to develop such activities as architecture, management consulting, construction, research and development, high-tech data processing, health care delivery, and manufacturing, to name a few. Much of the required infrastructure is already in place in Freeport. Success in this effort may involve confronting some taboos in Bahamian politics, but the 21st century is just three years away and time is fleeting

.

Conclusion

I want to conclude on an upbeat note. I don't want to leave this audience and the Bahamian people with any sense of despair. Rather, I believe that a few key changes in economic policy can lay a foundation of renewed growth and optimism. If The Bahamas can double its rate of economic growth, from an annual average of 2 percent to 4 percent, which I believe is possible, its people will gradually come to enjoy a living standard closer to that in the United States and Western Europe. At a higher growth rate, there will be more and better jobs for the graduating classes of young Bahamians.

Thank you for your kind attention.