The State of the Bahamian Economy, What can be done to Realize our Economic Potential?

Keynote Address for CFAL's 5th Triennial Educational Retirement Seminar

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By

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I. Introduction

Good Morning,

I would like to begin by thanking the management of Colina Financial Advisors Limit (CFAL) and its parent company Colina Holdings Bahamas Limited (Colina), for inviting me to speak to you today on this important topic.

As this company celebrates 20 years of service to The Bahamas and the wider region, it is only fitting to look back at your accomplishments, including the exponential increase in your assets under management from a mere $2.5 million in 1997 to over $1.6 billion at the end of 2016. To put this in perspective, the National Insurance Board also had investments of approximately $1.6 billion at the end of 2015, with a comparatively flatter growth trajectory since 1997. It is fair to say that CFAL has become an example of an internationally successful Bahamian owned and managed institution.

To put today's presentation into context I would like to spend some time briefly reviewing the path that we have taken to get our economy to this present point. Then I would like to discuss a bit about how the economy is currently doing and what the outlook looks like. I would then focus on some key areas in which the Central Bank's contribution is important to increasing our long-term economic growth.

II. Understanding Our Potential

First, however, a word about economic potential.

In economics we consider how an economy can operate to fully exploit existing capacity in the short & medium-term, as well as how it can strategically develop more capacity in the longer-term. There are discussions ongoing in The Bahamas in both respects.

In the immediate and very next few years, the required actions amount to using the current skills we possess to be more productive in the workplace—particularly from the cultural mind-set, not of being **able** to, but of being **willing** to do more. It means, when tied in with tourism, that we are able to extract higher hotel room occupancy, higher room prices and that we get the cruise visitors to spend more within our destination. It also means that to the extent that government or regulatory decisions stand in the way of executing viable business proposals, the system becomes more agile in addressing business needs.

Beyond the present, we agree that we should tackle the structural issues that make the business environment more competitive, in the sense that, internationally, we are a more preferred and viable place from which to do business; and also in the sense that the economy finds viable paths towards more sustainable development that reduce investment uncertainties and provide more resilient and diversified livelihoods.

This touches on the comprehensive discussions that have already been put forth in the National Development Plan. Now, the identified reforms have to be adopted, including putting the government in a healthier financial position; making the delivery of government services and the administration of regulations more efficient; making the financial services sector more efficient and, making our economy and infrastructure more resilient to climate change.

The reforms have to begin now and they have to be comprehensive.

III. A Recent History of the Bahamian Economy

In tracing through our recent economic history it is the fiercely increased international competition facing all of our industries that particularly stands out, in an economy where the key structural features have remained the same.

From as early as the 1950's the Bahamas transformed tourism from a seasonal, winter business into one that provides year-round employment. As the Government began to promote summer vacations, tourist air arrivals rose dramatically. In addition, with support from the Hotels Encouragement Act, we experienced a construction boom, with the development of zones such as Lyford Cay and Paradise Island becoming entrenched before the end of the 1950s. By 1965, there were more than 40 hotels and gated communities with 43 airports throughout the Bahama Islands.

In the 1970s, the Government began to encourage investments outside of tourism, including development in the agricultural and industrial sectors. However, after the 1970s oil crisis, investments began to wane, and several major production companies had to close.

During the 1960s, The Bahamas also took a more serious approach to international financial services and attracted robust returns from the sector in the three decades that followed. Again, other countries learned from our economic model and became fierce competitors even before the jurisdiction started experiencing pressures in the last two decades from global political initiatives.

Our experience in both tourism and banking demonstrate that a country has no exclusivity when it lands on a good economic model. Staying competitive requires strenuous, national effort.

The other important episode in our relatively young economic history has been the stellar success with Grand Bahamas as both a centre of tourism and industry in the period leading up to, and post-independence. Again, international competitiveness has fallen off for more than the last decade.

IV. The Current State of the Economy

Currently the economy is still recovering from the effects of the 2008 recession. The Bahamas is expected to experience very mild growth in 2017, after contracting on average for at least the last two years. Over the medium-term annual growth is expected to average less than 2 percent, once the economy has transitioned from the extra boost provided by Baha Mar.

In terms of a regional comparison, while The Bahamas maintains the position as a leader in overall arrival volumes, owing to a strong cruise component, markets such as Cuba, the Dominican Republic and Jamaica have experienced faster growth in recent years. Over the last 5 years Cuba's average annual growth rate in tourist arrivals was 8.1%; followed by the Dominican Republic at 5.1%, Jamaica at 4.6%, and then The Bahamas at 2.4%.

Baha Mar has headlined the recent expansion in tourism capacity, and near-term prospects for some boost in growth and domestic employment. The move to complete the project, together with an increase in construction activity—from post hurricane rebuilding activities—contributed to the recent, almost 2 percentage points reduction in the unemployment rate to just below 10 percent in May of 2017.

There are also other significant tourism developments that will support construction in the near-term. However, until the local housing market recovers and local business investment accelerates, the domestic component in construction would remain below its long-term potential.

For The Bahamas, inflation continues to be mild, given the close link with the inflation rate of the United States—our main trading partner—and the stability provided by the fixed exchange rate regime. In addition, the contribution to inflation from energy prices has decreased dramatically since 2011. However there has been some recent uptick, due to less efficient domestic energy production.

In the local financial sector, conditions are stable, but there has been continued build-up in bank liquidity, due the severely constrained private sector lending activity since 2008.[1] A much stronger pace of credit expansion is only expected to occur as lending risks become easier to manage within banks. This requires a continued pickup in economic activity, follow-through in getting a credit bureau framework in place, and more aggressive resolution of the existing loan delinquencies.

That said, the Central Bank is already encouraged by the reduction in delinquent or non-performing loans (NPLs) that has occurred, with help from direct government intervention, sales of bad debt by banks and the momentum from the improving financial circumstances of some borrowers.[2]

Another positive sign for the economy has been the performance of the external reserves. Since 2008, The Bahamas has seen some year-over year growth in the reserves, starting with the boost from the Special Drawing Rights (SDR) allocations that the IMF provided to all member countries in 2009, and one-off boosts from transactions such as: the privatization of BTC and capital inflows into one of the commercial banks. The balance that Government maintained in its foreign currency debt operations, between debt repayment and new borrowings has also helped, as has the continued, modest annual net inflows through the private sector. As oil prices subsided, there has also been less drain on the reserves from fuel imports.

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[1] One measure of bank liquidity, excess reserves (cash and balances placed with the Central bank), was just over $800.8 million at the end of August, representing a $78.1 million gain over the first eight-months of 2017, while the broader excess liquid assets—which include holdings of Government securities—grew by $164.8 million to $1,611.9 million over the same period.

[2] Commercial banks' asset quality has improved considerably over the last four years, mainly due to sales of large chunks of NPLs by two commercial banks, including the Bank of The Bahamas. These transactions, when combined with the general improvement in economic conditions and other credit restructuring activities, resulted in banks' NPLs falling by over $300 million since 2013 to $646.5 million at the end of August. As a ratio to total loans, the NPL rate has fallen by 5.2 percentage points to 10.1%, over the same time period.

In the last two years, reserves have seen mid-year peaks above $1 billion. At the end of September 2017, external balances stood at $1,064.9 million, a gain of $160.9 million over the first nine months of the year.

The improvement targeted over the medium-term, is for the reserves to represent a larger ratio of average imports. This speaks to achieving even more robust growth in tourism and other foreign exchange earning activities. The Central Bank is also targeting a higher ratio of the reserves to its Bahamian dollar currency liabilities. This is to be achieved primarily by reducing the amount of outstanding credit to the government. It is one of the areas of focus in the proposed reforms to the Central Bank Act that would put more legal restrictions on lending to government.

It is important to note that the foreign reserves are the first line of support for maintaining the value of the Bahamian dollar fixed exchange rate. Reserves also provide a level of confidence, along with other sound reforms, to allow the economy to move further along a careful path of exchange control liberalisation.

The experience of the recession and the slow recovery also propelled the deterioration in public finances since 2008. Any improvement in the government's finances over the medium-term, particularly in the public debt ratios, will provide the context for increased private sector confidence and could support accelerated, but careful reforms in the foreign exchange markets, in so far as outlets to investment opportunities outside The Bahamas are concerned.

V. Achieving Our Economic Potential - A Central Bank's Contribution

Where does this place us in terms of unleashing our economic potential? Government, the private sector and regulators all have coordinated roles to play in this process. From a Central Bank's perspective, the goal is to ensure that the financial sector is dynamic and resilient, fully supporting the desired levels development within the overall economy. The Bank has placed strategic focus on strengthening the financial sector, promoting financial inclusion and literacy and supporting targeted exchange control liberalisation measures.

As to fiscal policy considerations, the Central Bank does have a vested interest in the success of the Government's fiscal consolidation agenda, with all of the reforms that are needed to support this process. Our contribution includes working in partnership with the Government to strengthen the public debt management framework. We have also set for ourselves the task of developing a regular fiscal policy advisory report to strengthen the technical content of the policy advice we provide to the authorities, on matters that overlap with the monetary and financial sectors.

Resilience through Lower Money Laundering & Terrorist Financing Risks

The recently elevate difficulties of banks in maintaining their international correspondent banking relationships (CBRs) highlight the importance of resilience, through the quality of our anti-money laundering (AML) and counter-financing of terorism (CFT) regime. For the Central Bank, measured success in this area would mean transitioning The Bahamas from a perceived high-risk to a medium-risk jurisdiction. In domestic banking services, this improved risk profile is vital to preserve the international payments channels for trade and commerce, such as for tourism and other exports; and for the ability to pay without hindrance for necessary imports. Our offshore banks also rely on their correspondent banking relationships to provide critical payments services for their clients. In the absence of such access, their business models would not be viable.

Although the correspondent banking landscape appears to have stabilised, the concerns are still heightened. Hence Central Bank's emphasis is on taking a comprehensive approach to AML/CFT supervision. The Bank is streamlining some of its routine work streams, to shift full-time resources into this area. We have nearly completed the setup of a special "Analytics Unit" within the Bank Supervision Department to monitor the quality of supervised institutions' risk management systems on an ongoing basis. This is a major enhancement from the past, when most of our supervised institutions engaged the regulator on their AML/CFT systems every few years, only in the context of the Central Bank's onsite examination visits.

The Central Bank is also collaborating with our regional central banking counterparts to develop appropriate policies to address the "de-risking" challenges in CBRs. This includes engagement with international agencies such as the Caribbean Financial Action Task Force (CFATF), the Financial Stability Board (FSB) and the IMF, to identify the areas for improvement in AML/CFT systems, and formulating technical assistance for both regulators and supervised insitutions.

In the Bahamas, there is also a comprehensive national effort to strengthen the financial sector safeguards, with all Bahamian regulators and law enforcement agencies coordinating their initiatives.

Resilience through Strengthened Financial Inclusion

The Central Bank's financial inclusion goals are also framed with AML/CFT goals in mind and tackling the culture of crime more generally. While there are elements of the strategy that are still being formulated, it evolves partly around achieving a reduction in the use of cash in the economy. Providing the public with affordable access to regulated electronic payment products and services is part of this strategy. This is why the Central Bank brought the regulations for e-payments services providers into effect in July of this year, to allow non-banks to participate in this space[3].

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[3] In July 2017 the ***Payment Instruments (Oversight) Regulations 2017,*** were issued and Gazetted. The Central Bank also published the ***General Information and Application Guidelines for Providers of Electronic Retail Payments Instruments and Electronic Money Products (Payment Service Providers).*** The Payments Unit of the Bank is currently receiving applications from businesses that are interested in providing retail electronic payment services.

Another priority is to increase the access of ordinary persons to banking services. For this, the Central Bank is developing simplified customer due-diligence guidelines that would benefit for low-risk persons who need a bank account for basic, every day transactions.

Ensuring that individuals have affordable access to regulated financial services would reduce the volume of activities that occur in the "shadows", and we expect overtime that it will improve the international risk profile of our jurisdiction.

Strengthening Commercial Bank's Balance Sheets

Also crucial to our efforts to ensure the soundness of the financial sector, the Central Bank pushing to accelerate the reduction in commercial banks' non-performing loans (NPLs). High NPL rates reduce banks' profitability by constraining the pool of assets that earn interest income. This also forces banks to incur direct losses from credit that is never repaid. For the consumer, the harm takes many forms: banks are reluctant to make new loans, they are more inclined to charge higher rates on the loans they do provide, and they are more likely to recoup their credit losses through fees on other products and services. Less profitable banks also are less enthusiastic about investing in infrastructure that improves the general quality and efficiency of the services that they provide.

The Central Bank is therefore starting to push for more aggressive resolution of NPLs. Banks are expected to intensify their efforts to collect on defaulted loans through asset sales and other recovery methods and to take the write-offs and increase loss provisionings in cases where necessary.

This is not a heartless exercise. Depositors' moneys are ultimately exposed. It would not be prudent to be content with just a gradual pace of correction knowing that our banks could easily suffer setbacks if another serious recession occurred. Reducing the NPLs is therefore about making this vital part of our economy even more resilient and positioned to carry out its financial intermediation role.

The Central Bank is also working diligently towards the establishment of a credit bureau to improve the medium and long-term environment for credit risks. A functioning credit bureau would empower banks to make safer lending decisions; to either exclude risky borrowers or to charge them higher interest rates. For those lower risk borrowers, interest costs could be set lower and more financing could be made available. The drafts of the Credit Reporting Bill and the Credit Reporting Regulations have already been finalized. It is anticipated that they will be taken up by the Government this year. We are quite pleased with the signals that the Government has been giving on this initiative.

Enhancing Consumer Protection and Financial Literacy

Enhanced consumer protection and financial literacy are also important ways that the Central Bank expects to play a role in strengthening the base of economy. The Bank's literacy campaign will equip consumers to be informed defenders of their rights in the financial services space, and to make sound decisions that promote their financial well-being. This touches on promoting good practices around savings and retirement planning, and for personal debt management. The Bank believes too that an office of financial ombudsman is necessary and we will work with like-minded regulators to promote this cause.

Supporting Careful, Targeted Exchange Control Liberalisation

Beyond improvements to the administrative processes for exchange controls, the Central Bank is also supporting gradual liberalisation in investment opportunities for Bahamians. The Bank is cognisant that in order to achieve our full potential as a country, we must find ways to increase the access which businesses have to financing, particularly when the local currency funding channels are limited.

In April, 2017, the Government, acting on the Central Bank's recommendations, announced a series of relaxation measures aimed at permitting certain categories of Bahamian owned businesses, mainly those with foreign exchange earning potential or whose business operations promote national development goals, to obtain foreign currency funding from either local commercial banks or from external sources (including equity arrangements or joint ventures with foreign partners). Under these arrangements, companies are permitted to access up to $5 million every five years if they are going through banking or direct investor channels. When international financial agencies, such as the World Bank and IDB, are involved, there is no pre-set limit on how much funding can be raised. Some of the approved sectors for external financing include agriculture & fisheries, manufacturing, transport, tourism, energy, health, infrastructure and construction & real estate for residential tourism. Although thus far, the volume of applications has been low, the Bank expects that as companies do the requisite research for viable projects the cumulative positive economic impact will expand.

The Central Bank also recognised the importance of supporting increased Bahamian ownership of international financial services firms and other direct ventures abroad. Since April 2017, there has therefore been increased allowance for access of up to $10 million in funding per investor project every five years. This accommodates funds raised locally and converted into foreign currency without having to pay the investment currency premium of 12.5%.

It is worth noting that these relaxations are in keeping with other measures announced in 2016, which targeted greater funding access for international portfolio investments. In 2016, annual limits for financing external portfolio investments, though products sold by local capital markets firms (the Bahamas Depository Receipt programme) was increased from $25 million to $35 million.

There also continues to be very active discussions with important local stakeholders on how to achieve further liberalisation of exchange control, particularly portfolio transactions. The

Central Bank's role has been to ensure that there is ample balance between the speed of liberalisation and accompanying reforms that maintain stability of the financial system and confidence in the fixed exchange rate.

The common thread in these discussions is that the Central Bank must do all that it can to ensure that the financial services sector is functioning efficiently and providing the lubrication needed for the economy to realise its true potential. Whatever we can do to reduce cost and increase access to intermediated domestic finance is important. As well, we have a role to play in upholding confidence in the system, and ensuring that all economic players have access to regulated services channels.

From our perspective, direct jobs creation only matters in the provision of international financial services. As far as the domestic financial system is concerned, the creation and preservation of jobs inside banks is not a first order concern. Employment creation must follow from the other economic activities that are stimulated through financial intermediation. In our international services sector; however, we do place a premium on direct jobs creation and preservation. For this it matters then how well we regulate the sector and uphold the reputation of the jurisdiction.

VI. Conclusions

Ladies and gentlemen, I have provided you with a snap shot of the current state of the economy, and outlined some of the measures we will have to take to achieve our economic potential. It is worth noting however, that as a small open economy, we are often affected by external economic conditions, especially those which impact our largest trading partners and therefore we must continue to carefully chart our course of development.

If nothing else, a retirement seminar such as this should allow us to appreciate the importance of planning for the long-term. From this process one should appreciate the long gestation period needed before certain of our efforts bear results. I hope too that you appreciate that inaction or delayed action, can be costly and that you would become champions of the reforms needed to position our economy for the decades to come.

Thank you for your attention.