A look at The Bahamas' Trade Deficit

International trade dominates our everyday life, whether we are shopping online for household items or the perfect gift. To our beautiful tourist hub, it has also been conducive to increased living standards, giving access to many desirables not made or produced in the islands such as cell phones, cars, furniture and appliances, and machinery. However, when it comes to trade, essential items such as food and fuel also top the list, making the region a net borrower to the rest of world. Although international trade heralded heighted conveniences, national development and living standards, it likewise amassed significant levels of debt.

The Caribbean region accounts for less than one percent of the world economy, which deepens the region's heavy reliance on international trade and tourism. This dependence has developed due to the region's lack of economic diversity or food security; boosting imports for food products, goods and fuel.

Moreover, the impact of climate change has devastated the region's bottom line, hampering economic growth due to catastrophic storms. Major hurricanes such as Irma, Maria, Matthew, and more recently Dorian have severely frustrated economic prospects and in some cases have decimated islands in its path. Further, English speaking Caribbean's unique categorization as "middle income[1]" nations further disadvantages the region's ability to successfully obtain necessary capital at affordable rates.

As a result, the region has incurred sustained current account deficits for decades. A current account deficit is the result of accumulated net claims of foreigners on

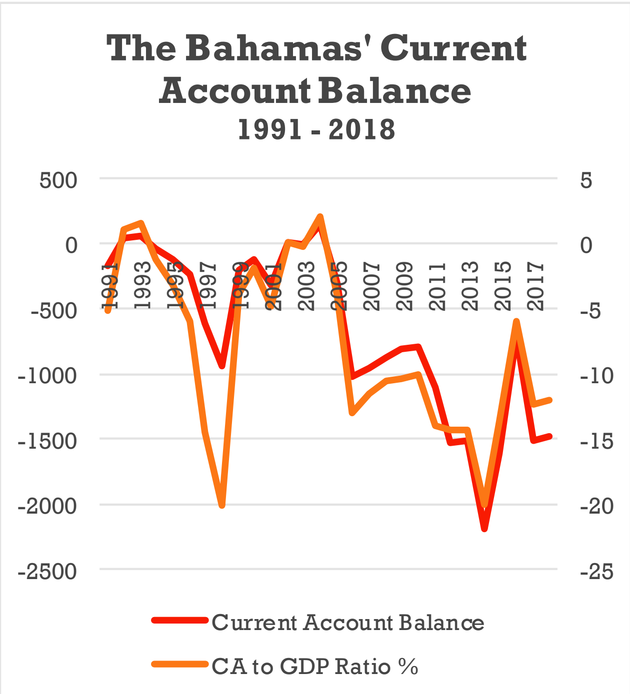
[1] According to the World Bank, they are defined as lower middle-income economies - those with a GNI per capita between $1,036 and $4,045; and upper middle-income economies - those with a GNI per capita between $4,046 and $12,535 (2021).

residents. This means that a country with a current account deficit is a net borrower to the rest of the world. Therefore, much attention is given to the rate of imports, international competitiveness, the exchange rate and the structure of the economy to ensure the current account position stays balanced, as consistent deficits (unless driven by productive growth), which require borrowing for repayment, are unsustainable and undesirable for any economy.

A lack of savings and investment may also perpetuate current account imbalances. However, although dissavings may drive higher current account unsustainability, if savings are a trade-off to investment, higher levels of production capacity may enhance future output and trade surpluses. As a result, this may justify current dissavings. Current account deficits are therefore favourable when they are used to drive economic growth, are financed sustainably and are fairly inconsistent. This can also be justified if an economy expects projected growth in the medium to long term.

Overview of The Bahamas current account deficit

The Bahamas' reliance on tourism receipts, foreign direct investment inflows and external borrowing to satisfy its current account deficits have persisted for decades. From 1992 to 2019, high levels of volatility in the current account prevailed due to international price shocks in oil, and the fluctuation in local and international consumer demand, which influences the level of imports from abroad.



Moreover, the United States and its prevailing economic conditions, as well as climate change and its influence on intensified storms, all play an important role in the state of the Bahamian current account position. Hurricanes have had a dynamic effect on the current account position, as reinsurance inflows temporarily boost external reserves, while necessary rebuilding efforts post-storm may severely hamper government revenues.

One can observe that significant current account influencers are seen in the Goods Sector and Travel Services. Similarly, reinsurance inflows from catastrophic hurricanes, particularly Hurricane Matthew in 2016 and Dorian in 2019, caused abnormal spikes in secondary income. The latter significantly boosted the current account balance towards the first surplus for the decade. Travel receipts dominates the services account; which is normally in surplus.

An Intertemporal Benchmark Analysis and Findings

In our analysis, the Intertemporal Benchmark Model (IBM) was used to evaluate the excessiveness of the current account deficit by predicting the optimal current account path. It acts as a benchmark of the actual current account balance. Historical trends identify several acute breaches in solvency due to extraordinary innovations, and the actual current and optimal current account balance do not converge in the long-run. We use the estimated VAR model to provide a rough forecast of the decline in the current account balance.

Despite several breaches in solvency, under current conditions, the IBM does give evidence to moderately support the sustainability of the Bahamian current account deficit, but it is critical to mention that the model does not factor in the sustainability of the manner in which the current account deficit is funded.

Policy Implications and Recommendations

Less reliance on external debt facilities and more focus on investment is imperative. The attraction of large capital flows through foreign direct investments, portfolio investments, and fiscal austerity remains fundamental. Economic literature remains conservative when it states that for sustainability, the current account deficit should not exceed 5% of the country's GDP (Opuki-Afari, 2007). Although nations have defied this benchmark, others have suffered the consequences of this breech. Still it is important to recall that the use to which deficits are applied is important, as would be the case if deficits represent productive capital inflows.

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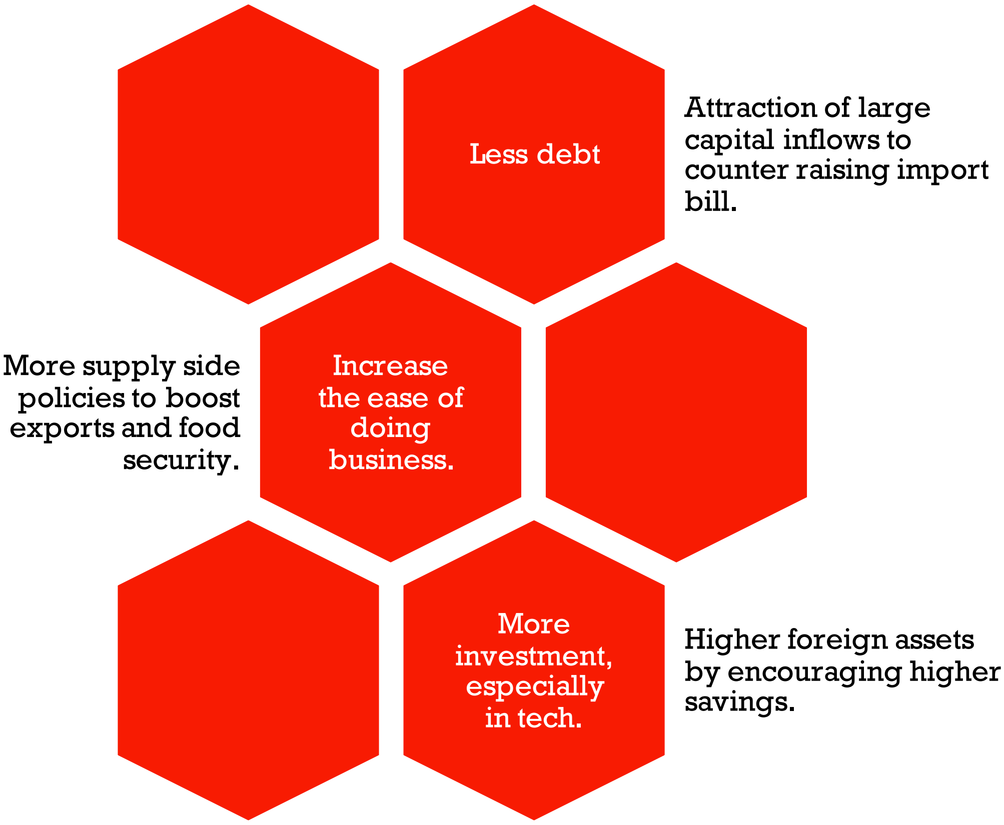
With regard to current account deficit sustainability, size does matter. Large capital inflows are the reason for significant portions of The Bahamas' import bill; because the investments require imported inputs. In the United States, large persistent current account deficit were supported by foreign investor demands for dollar assets (such as Treasury Bills). Without this demand, the value of the dollar would depreciate, thus reducing the size of the current account deficit. Adjustments of the exchange rate is often used or prescribed to cure current account imbalances. This is particularly the case, when accumulating liabilities to the non-residents are not considered sustainable. However, The Bahamas has always maintained a fixed exchange rate, set at parity with the United States dollar since 1966. As the United States is The Bahamas' number one trading partner, this peg helps to facilitate ease of trade, provides the nation with exchange rate stability and encourages more competitive exports.

In The Bahamas, exchange rate adjustments are not used to regulate current account imbalances. Rather, to the extent that the deficits are driven by imbalances between private consumption and income, the pressures are exerted on the external reserves. In such instances, the Central Bank is able to regulate a combination of the supply and demand for domestic credit, to slow growth in credit and limit the amount of spending on imports that is financed from credit. If Government deficits are the source of pressures spending on imports, there could still be reason for corrective adjustments, particularly if the deficits are not associated with public sector investments that generate long-term economic returns. Even still, the returns from such investments would be expected to match or exceed the cost of the debt that is accumulated. The returns could materialize in terms of improvements in the ease of doing business, or increased competitiveness and relatively low inflation rates, which are particularly important for countries like The Bahamas.



As aforementioned, pressures are exerted on external reserves. Therefore, quality of foreign assets are imperative during times of economic hardship to absorb market shocks. The Bahamas has maintained high levels of external reserves which

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meet, and in many cases exceed, international benchmarks. These help to absorb shocks due to global downturns which may impact the services sector and are vital to avoid insolvency and a balance of payments crisis.

An introduction of supply side policies to improve competitiveness of the domestic industry and boost exports may provide some support, as government borrowing may stimulate aggregate demand which further increase the import bill. Nonetheless, the reduction of domestic consumption, is not always the best response, when it would further depress an economy. However, it could increase the amount of effort that the government would need to take to restore healthier finances, once the economic shock dissipates.

Where it is competitive, production of more local commodities may also lessen the import burden, as well as boost the exports necessary to balance the trade deficit.

Building Resilience for the Future

As the Bahamas continues to manage mounting climate change risk, rising debt, diminishing export competitiveness and a rising import bill, reforms will have to continue to secure increased resilience. COVID-19 has arrested the tourism industry, depleted revenues; and imposed substantial social welfare costs on the government. Recent sovereign debt downgrades, have also imposed higher premiums on the cost of public debt. Resilience that bolsters sustainability of the current account, could come from new exploitation of new competitive niches, such as in blue and orange economy—that is the abundant marine and cultural resources---and a more general investment of resources and efforts in diversification (even within the tourism product). Resilience also encapsulates the benefit of increased fiscal savings over the medium-term; and strengthening the private sector’s capacity to save and better insure against climate change risks.

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