The Bahamas' Sovereign Ratings Downgrade: The Central Bank's Role in Reforms to Strengthen the Outlook

by Governor John Rolle

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1. Introduction

I commend The Bahamas Chambers of Commerce and Employers' Confederation for convening public and private sector officials to discuss the current state of the Bahamian economy. I am slated to speak on the impact of the recent sovereign credit ratings downgrade by Standard and Poor's (S&P), with reference to the foreign reserves of the Central Bank, and address the issue of the strength of our currency. I will preface this with a brief look the recent economic performance and the Central Banks's assessment of the outlook. I will also highlight some relevant policy initiatives within the influence of the Central Bank to make the economy more resilient, such as targeted exchange control liberalisation that might help to address the private sector's vibrancy. These all overlap with the recurrent themes in rating assessments of both S&P and Moody's. The ratings experience has also generated discussions about our choice of exchange rate regime and whether dollarisation is a viable option for The Bahamas. I will end my remarks with some comments on this subject.

This is a good point to state the key takeaways from this presentation:

- First, the outlook for the external reserves of the Central borders between stability and incremental improvement. This maintains the support necessary for a fixed exchange rate, and dismisses the notion that The Bahamas is in the "danger zone" for devaluation.
- Second, on the basis of tourism and related investment inflows, the Bahamian economy is expected to strengthen over the medium-term; even though the credit ratings shift poses increased interest rate challenges for the Government.
- Third, the Government will continue to enjoy ample access to external financing, contingent upon its willingness to accept higher interest premiums. Hence, our

internally motivated reasons for achieving fiscal consolidation will continue to be the dominant determinant of whether we achieve meaningful success in this area.

- Fourth, any stable transition from the currency peg to a positon of dollarisation, as is often advocated, would require significant structural improvements and a level of adjustment that corresponds with a vibrant private sector and an economy with far superior foreign net exchange earning capacity.

2. Making More Effective, Independent Use of Data

Before getting into the details, I would like to point out a very critical contribution that is missing from within the private sector. Despite the abundance of data, the publication of independent, structured analysis of the economy is extremely uncommon in practice. One misconception is that The Bahamas lack sufficient objective information from which to draw inferences about the economy. On the contrary, the Central Bank publishes a wealth of data, some of which also feed into in international statistical reports. Although there are some areas that need improvement and some compilation methodologies that need to be upgraded, the available data gives a good feel for indicators that track performance in the foreign exchange earning sectors, construction, the financial sector and public finance. One void that the private sector has to fill therefore is to do more independent analysis of these outputs--particularly in ways that provide analytical checks and balances to the work that is now almost exclusively being done by public agencies.

For the Central Bank, the focus is now to make strategic improvements to data quality. One priority will be to enhance the presentations on public finances (in the near term) to draw together the various financing components already in the Central Bank reports; and cooperation with the Ministry of Finance on the longer-term project to present the accrual version of the accounts. Using consolidated value added tax (VAT) data the Bank also intends to draw out more timelier conclusions about tourism and other private sector activities The Bank will also use more accessible VAT consolidated data to strengthened the balance of payment data coverage and therefore identify more of the inflows that are now showing up as larger errors and omissions in our reports

3. The Current Economic Assessment

What does the data say about recent performance?

Again, the Central Bank projects an incrementally favourable outlook for foreign reserves and inflows, with strengthened tourism performance leading this process. Only this justifies the recently more relaxed interest rate posture. With the fixed exchange rate, a key objective of the Bank to has been to only accommodate credit driven stimulus to domestic demand and resulting imports, when foreign exchange inflow prospects improve. The exchange control (EC) liberalisation proposals which I will outline shortly speak to reforms that would aid the foreign exchange sectors of the economy.

The quality of local banks' balance sheets is a recurring highlight in recent ratings reports. This draws attention to the urgency of seeing credit quality measures improve over time. The Central Bank expects this process to be very gradual. It has already begun, with the non-performing loans (NPL) rate falling by more than 2 percentage points in 2016 to 15.1%, and compared to a rate above 16% at the high point in 2014. This has been helped by a mixture of factors such as stabilizing economic conditions; the sale of non-performing mortgages to private investment entities; continued aggressive debt restructuring by commercial banks and positive inroads with the Government's mortgage relief program.

While lending conditions in the economy remain tight, some guarded loosening is evident. There was a very mild continuation in consumer lending growth in 2016 that is projected to continue in 2017. However it reflects very selective lending to low-risk borrowers. Residential mortgage lending is also showing signs of strengthening, even though the aggregates amount still contracted in 2016 owing to the aggressive disposal of NPLS. Alongside foreign investment flows into tourism and residential tourism projects, domestic mortgage lending is a key indicator of support for construction.

The passage of the credit bureau legislation will be the most important structural reform to the credit markets. It will help to address both ease of access and cost concerns. The Central Bank has already provided the final draft of the proposed framework to the Government, with the anticipation that it will be enacted after the mortgage relief bill is passed.

The data meanwhile shows that the financial services sector remains in transition. International operations face external pressures that require further strategic adaptation, as the sector's value proposition becomes more detached from tax sheltering activities. Both the domestic and international sectors, meanwhile, are undergoing cost consolidation and are outsourcing significant parts of their operations. Both sectors are also confronting heightened risk of loss of access to correspondent banking—the so-called de-risking phenomenon.

Along with other Caribbean central banks, we are developing multifaceted responses to the de-risking threat. A harmonized approach to strengthening frameworks to combat money laundering and terrorist financing (AML/CFT) is considered critical. Continued international engagement at the political level and within regulatory standards setting bodies also has strategic importance, to tackle unfounded negative perceptions about regional jurisdictions. Such international outreach will also seek to encourage more tailored application of standards in smaller jurisdictions, in ways that do not undermine financial inclusion for poor and vulnerable persons, while fostering the desired effectiveness of safeguards against criminal abuses.

There are also some strategic responses that are important to reducing medium-term vulnerabilities from changes in the correspondent banking landscape. For example, there is consensus that The Bahamas and other regional economies must target significantly reduced reliance on cash-based transactions, and must embrace wider, more regulated adoption of electronic money solutions. The Central Bank of the Bahamas already has an active payments system reform agenda with this focus, and will begin licensing non-bank solutions providers in 2017.

4. Significance of the Ratings Action

Let me turn to the significance of the credit rating actions.

Curiosity about the economic impact of ratings downgrade is not unique to the Bahamas, as it continues to receive attention by economists in other international settings.[1] Sovereign

[1] Hanusch, M; Hassan, N, et. al (2016). The Ghost of a Rating Downgrade: What Happens to Borrowing Costs When a Government Loses its Investment Grade Credit Rating?. World Bank, Macroeconomics and Fiscal

ratings are intended to characterize the relative ability of governments to service their debt obligations in the future. In this case, both the policy and macro-economic environment in which sovereigns operates are factored. For a very small economy like The Bahamas, being on the receiving end of external developments also matters, as well as how effectively domestic policies address resilience in the face of such forces.

The Bahamas has cumulatively experienced two distinct ratings periods. The first was prior to the 2008 global financial crisis, when ratings were stable. Moody's initially assigned an A1 to the foreign currency debt in 1998 and this was followed by a rating of A- by S&P in 2003. Then, as the country traversed the period after 2008 recession weaker fundamentals emerged, and assessments shifted lower, until the latest move to sub-investment grade.

Such downgrades have still been less aggressive for The Bahamas than for most countries in the Caribbean region—which speak to the point that the fundamentals and fiscal position were not as deteriorated as most elsewhere in region. On a global scale fiscal consolidation in the post-2008 period has more of a priority for government on the whole, with ratings pressures that go well beyond the Caribbean region.

Nevertheless a critical concern for The Bahamas, beyond whether the speed of deficit reductions can be accelerated, is whether potential growth prospects can be improved. Faster growth would drive the much needed accelerated growth in the fiscal revenue base and expedite recovery in banking sector credit quality.[2]

Is Access to External Financing or FDI at Risk?

One concern around negative ratings action would be whether the Government's access to funding would be prematurely constrained, forcing an abrupt curtailment in operations. I do not foresee prospect for such drying up of access to international credit. Instead, it is

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Management Discussion Paper No 13: http://documents.worldbank.org/curated/en/241491467703596379/pdf/106667-NWP-MFM-Discussion-Paper-13-SARB-CreditRating-28-Jun-2016-PUBLIC.pdf

CANTOR, R; PACKER, F. Determinants and Impact of Sovereign Credit Ratings. *Federal Reserve Bank of New York Economic Policy Review*. 2, 2, 37-53, Oct. 1996.

[2] Hurricane Matthew as also shocked that delayed the consolidation process, although arguably it should not be treated in the same way as the structural or persistent factors than constrain expenditure reduction.

expected that the public sector will have to put more emphasis managing any near-term uptick in external financing costs. The Bahamas remains in a strong position to borrow from abroad, and will in fact have to continue to be disciplined in resisting excessive credit that might be pushed in its direction.

Ordinarily, the private sector would also be capped by the sovereign credit rating, but the Bahamian model is not significantly exposed in this fashion. International capital markets, where the sovereign credit ceiling would be expected to apply, are not a source of funding for domestic owned firms. Moreover, for foreign investments that are still the key drivers of the economy, it is expected that the financing risk determinants evolve more around prospective export demand from outside The Bahamas (most notably tourism). In addition The Bahamas is not in a current state of where a negative ratings experience would either prompt or forewarn of responses by the Government that would threaten ownership rights or introduce costly constraints on doing business.[3] In such circumstances FDI could indeed be more directly at risk.

De-Emphasizing the Exchange Rate Peg

At this point, I wish to address a subject which has been a topic of lively conversation among the public for some time. The Central Bank has stated on several occasions, in different forums, that there is no direct link between the recent credit downgrade, the adequacy of country's external reserves and by extension, the viability of the exchange rate.

Indeed from the end of 2008 to 2016, reserves almost doubled to $904.0 million from $562.9 million. Since 2011-2012 all of the measures of varied measures of import coverage have shown improvement. This is notwithstanding the less than rosy picture of economic performance.

The reserves position has held up for a number of reasons. The foremost is that domestic credit pressures were kept in check. Meanwhile pressure from higher prices and shifts in the capital base of the domestic banks were cushioned by one-off inflows related to the

[3] One study that looks at these issues is that of Nguyen zu Knyphausen-Aufsess (2014):
Nguyen, J, and zu Knyphausen-Aufsess, D.(2014). "The Impact of Sovereign Credit Ratings on Corporations: A Literature Review and Research Recommendations." *Financial Markets, Institutions and Instruments*, 23, no. 3: 125–78.

sale of part of the Government's ownership interest in the BTC ($210 mill. in April 2010); a special issue of Special Drawing Rights (SDRs) by the IMF in August and September 2009, amounting to $178.7 million and; capital inflows in some quarters of the banking system. The Government also maintained a balanced approach in its debt management operations with a good mix of foreign domestic currency financing to support refinancing and new investments. More recently, the pressures on the oil bill which have fallen.

Over fixation on the reserves can ignore the fact that the bulk of the foreign exchange flows through the economy pass through commercial banks, and rarely sit on the Central Bank's balance sheet. The public confidence maintained in the banking system has always ensured that these flows are not hoarded, but made available to fund required imports of goods and services.[4] On the inflow side the amounts which are handled by commercial banks exceed $5 billion.[5] Meanwhile a strong correlation between inflows and private sector demand for imported goods and services has kept sales of forex closely aligned with inflows. The contribution of monetary policy has always been to ensure that this correlation is as strong as possible, hence the emphasis on the influence on credit expansion as an added source of demand for foreign exchange.

5. Some Interventions to Strengthen the Outlook

The short-term goal of the Government is to stabilize the credit ratings and improve the outlook. In this regard, both S&P and Moody's currently project a stable ratings outlook. The strength of the country's economic and fiscal performance, will influence evolution. The pace of progress on positive structural reforms will also affect how swiftly the outlook improves.

[4] The Exchange Control Regulations meanwhile gives unfettered priority to imports of goods and services over outward financing of investments.

[5] The total values of foreign exchange transaction that impact the economy further exceed $5 billion. Most of the public sector's foreign currency debt enter directly via the Central Bank, which the Central Bank supplies most of the sector's outflow needs (dominated by debt servicing, fuel for electricity generation and purchases of foreign services) from the same receipts. A significant , amount of foreign exchange cash also passes though the private sector while significant FDI financing directly funds recorded imports and services, from capital resources that are maintained outside the Bahamas.

Increasing growth rate potential above what is now projected at less 2 percent per annum will help in the recovery of the sovereign rating. In this regard a faithful execution of the National (economic) Development Plan would yield significant returns. Many of the necessary reforms identified in the Plan would provide medium and longer-term benefits addressing, among other factors, productivity boost and strengthened foreign exchange earnings potential. There are also substantive necessary reforms that fall under the ease of doing business.

Targeted Capital Account Liberalisation

Some growth enhancing reforms are within near-term reach. In the Central Bank's case this includes swift improvements that can be made in the administrative processes for exchange control. The other is more tailored easing of access to external financing.

The Bank is therefore seeking the Government's endorsement of relaxation proposals to permit foreign currency financing for Bahamian owned businesses, from both local commercial banks and external sources. The external sources would include private investors, private financial institutions and the private sector arms of development agencies such as the IDB and the World Bank. The proposals will respect areas of the national economic policy that preserve certain activities exclusively for Bahamians. In these cases, secured credit or equity funding would be capped so that the super majority local ownership is never at risk of forfeiture to a non-Bahamian.

The proposed financing ceilings that would apply in the relaxed framework are less likely to be binding on small and medium-sized business. For larger firms that seek greater funding amounts, the discretion currently exercised by the National Economic Council (NEC) of the Government would continue to apply on a case-by-case basis.

Under the proposal, the following activities would be eligible for access:

1) Agriculture & Fisheries
2) Manufacturing
3) Transport (Land, Sea and Air)
4) Tourism (Hotels & Restaurant)
5) Construction and Real Estate for Residential Tourism
6) Energy & Energy Conservation

7) Education
8) Health
9) Telecoms, ICT, Infrastructure

These are activities that would either have net positive foreign exchange impact, or satisfy critical development goals, having a similar positive prospective BOP impact in the medium to longer-term.

However, it must always be cautioned that access to funding will remain linked to country ad business risks, and perceived effectiveness of systems that enforce contracts and property rights. It is expected therefore, that some forms of financing will not be realized at their full potential until effectiveness is enhanced in within important legal frameworks for doing business.[6] Nevertheless, we expect these reforms would generate favorable gradual returns, in some instances as business cases around tourism-linked prospects strengthen.

Strengthening Public Debt Management and Governance

One of the Central Bank's other contribution will be to continue to work with the Ministry of Finance in improving the public debt management framework. Efforts are already underway to introduce a market-based framework for pricing new securities through the development of an auction mechanism for issuing new Government bonds. Related to this is the dematerialization of existing debt securities and establishment of a centralized securities depository for cost efficiencies and positive downstream effects on the development of private sector debt markets.

The Central Bank has also received the government's endorsement in principle to modernize the institution's legal framework, which will introduce more conservative parameters around providing credit to the public sector. This will motivate accelerated reforms to make the market based mechanics more effective.

[6] Secured lending prospects for example will be strengthened once the land registry systems is modernized.

6. Would Official Dollarisation Mitigate Economic Risks?

Before concluding, I should speak to the prospect for official dollarization. This is a topic on which the Central Bank is prepared to sponsor a separate seminar later this year, so that the private sector can fully understand the structural reforms and adjustments that would be required to engineer such a transition without an abrupt devaluation or destabilizing impacts on the banking system. I say this because it is often foreshadowed as a state without exchange controls of any sorts. Liberalization in a non-destabilizing fashion will continue to be gradual, and most sustainable within an economy with a stronger structural base, and more resilient foreign exchange earning capacity. For one thing, The Bahamas would still have to accumulate a larger handover stock of foreign reserves. Although monetary policy would be obsolete in such a world, but the need could be more critical for the financial sector regulator. Needs would also persist for economists, statisticians and sound fiscal frameworks. The Central Banker would be reborn.

7. Conclusion

Again it must be stressed in the context of the ratings downgrade that the medium-term economic outlook is improving for The Bahamas. With it the prospects to influence ratings upgrade will increase. Achieving a more accelerated trajectory of fiscal consolidation would add further ameliorate the sovereign risk profile, albeit this would require more entrenched structural reforms that boost potential growth. This includes the focus on the credit markets, prudent review of the exchange controls and strengthening the public sector's debt management framework, all of which currently enlist some input from the Central Bank. The private sectors' interest and involvement in such policy discussions is always a good thing. I therefore look forward to staying engaged with the Bahamas Chambers of Commerce and Employers' Confederation.

Selected Figures and Tables

Table 1: Regional Sovereign Credit Ratings Trends

	S & P		Moody's		S&P		Moody's	
	2008				2016			
	Rating	Outlook	Rating	Outlook	Rating	Outlook	Rating	Outlook
Bahamas	A-	—	A3	Δ	BB+	Δ	Baa3	Δ
Barbados	A-	—	Baa2	Δ	B-	—	Caa1	Δ
Belize	B	Δ	Caa1	Δ	CC	—	Caa2	Δ
Jamaica	B	—	B1	—	B	Δ	B3	Δ
Trinidad & Tobago	A+	Δ	Baa1	Δ	A	—	Baa3	—

Source: S&P and Moody's.

Figure 1: Selected Economic Indicators

Fig 1A: Real GDP Growth (%)

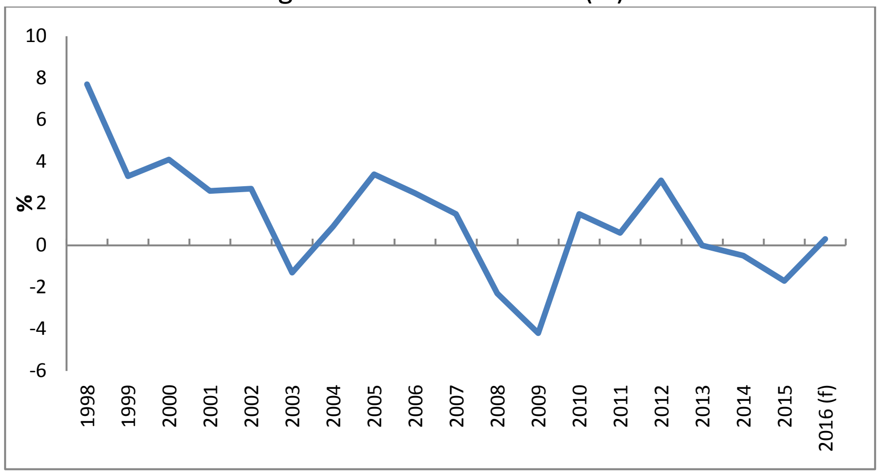


Fig 1B: National Debt (% of GDP)

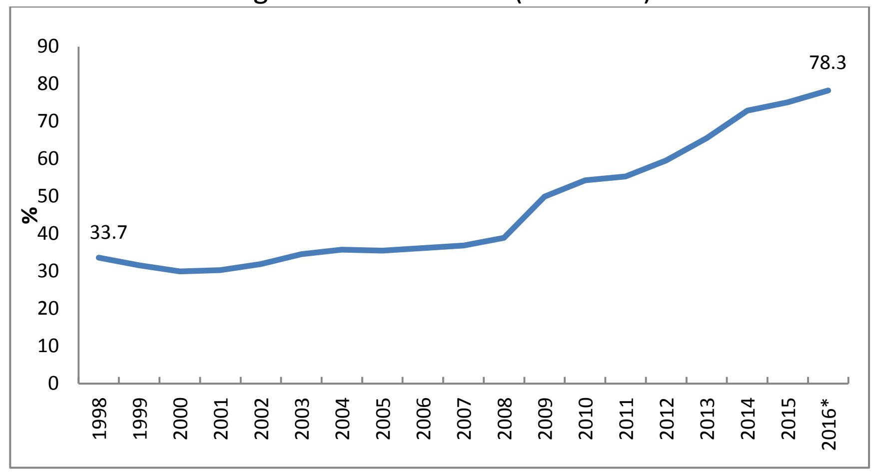


Fig 1C: Fiscal Deficit (% of GDP)

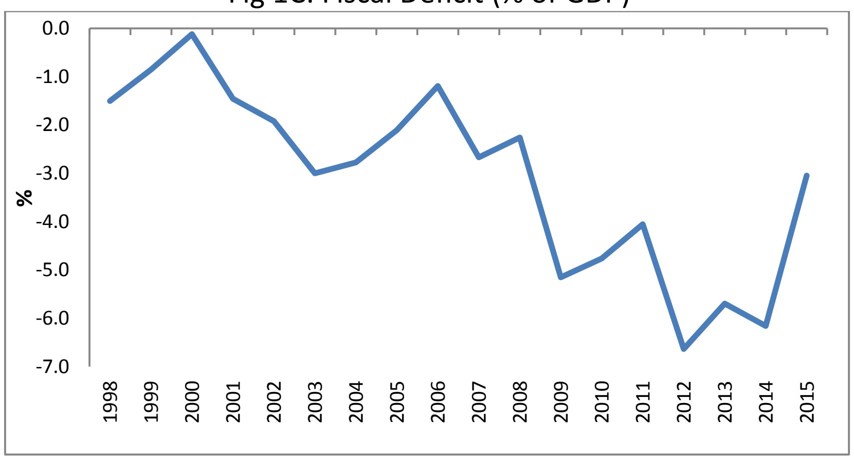
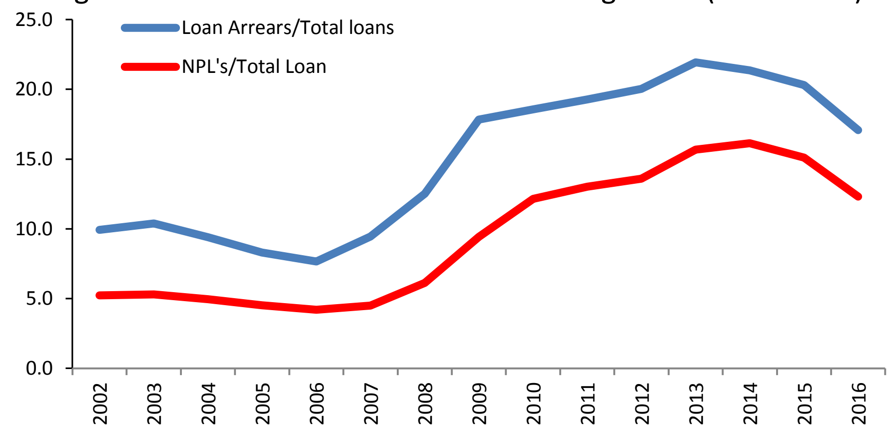
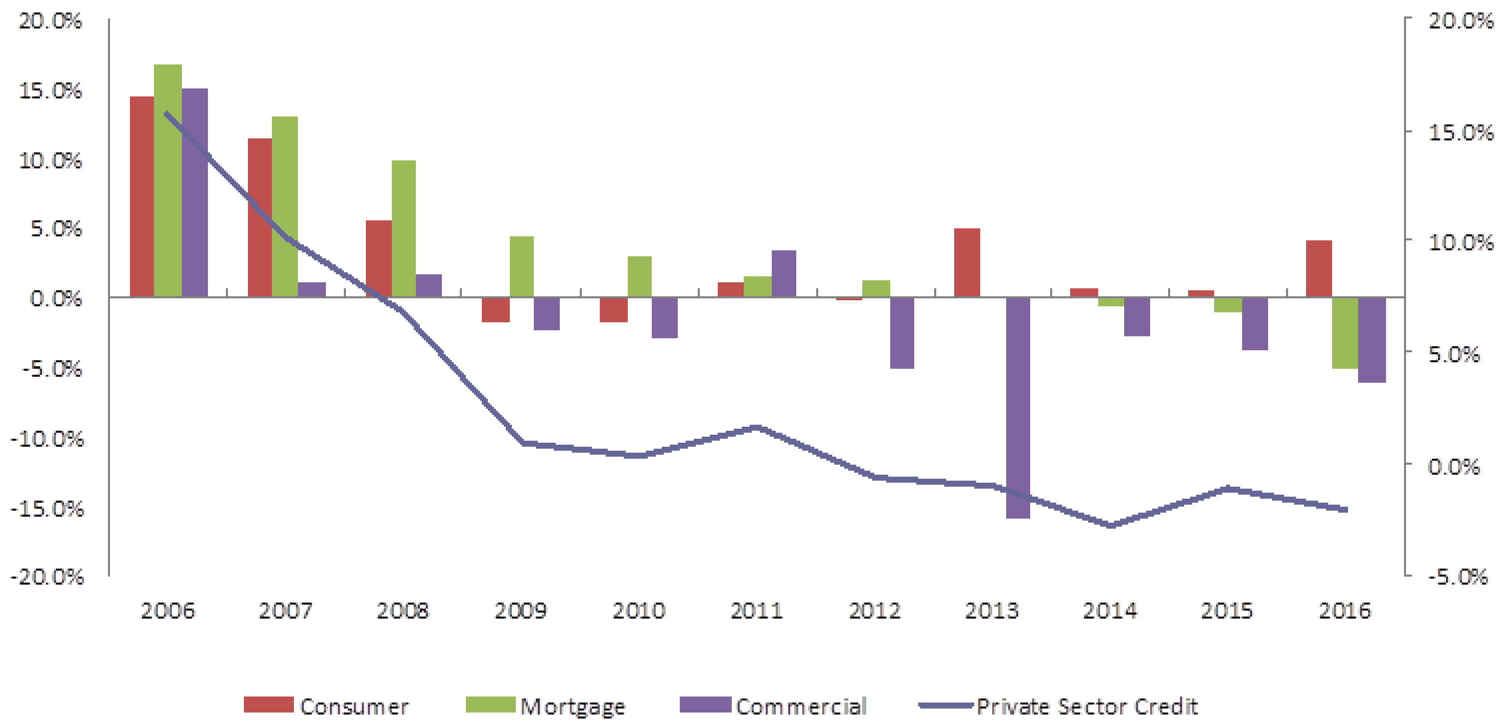


Fig 1D: Private Arrears and Non-Performing Loans (% of Loans)



Sources: Central Bank of The Bahamas and Department of Statistics (GDP data)

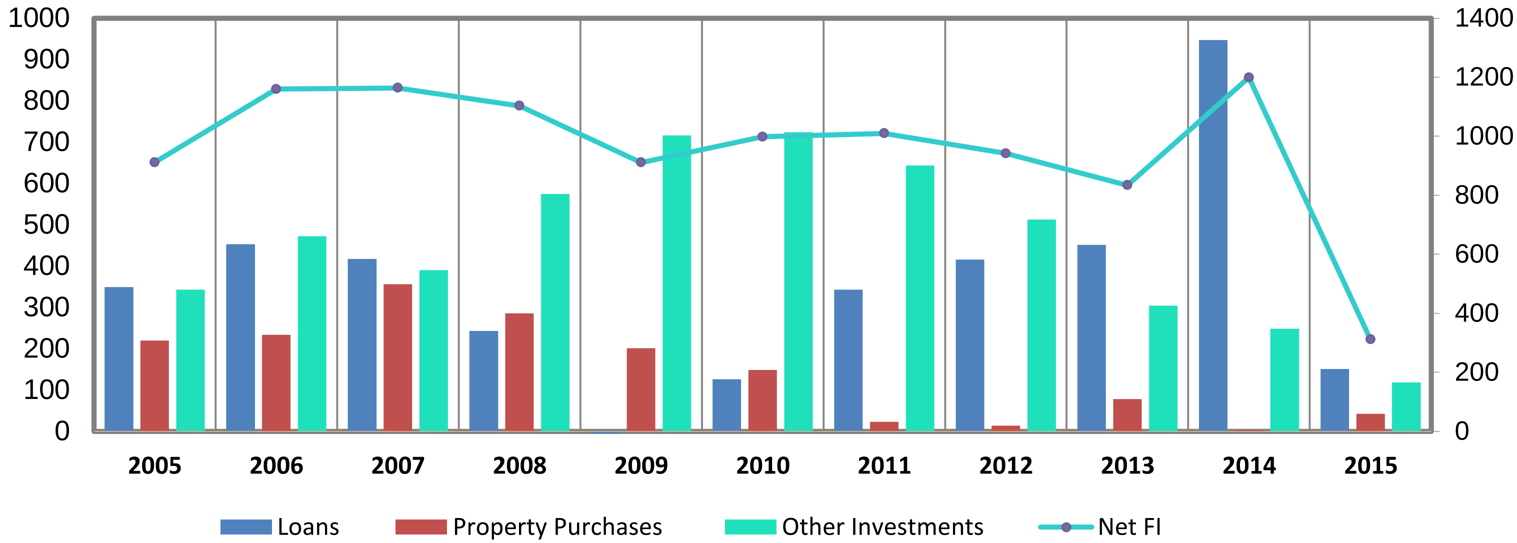
Figure 2: Bahamas Private Sector Credit Growth (%)



Source: Central Bank estimates.

Note: Total Credit changes are shown on the right hand side; component changes are on the left. “Mortgage” refers to residential mortgages.

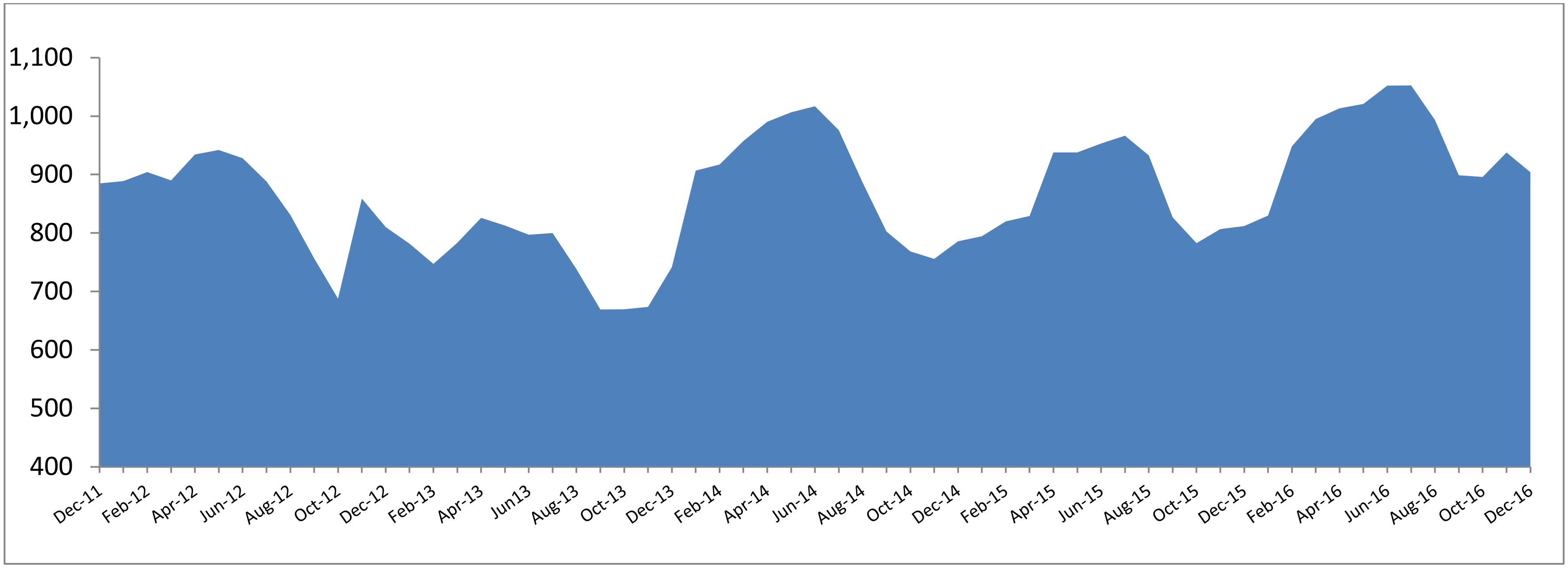
Figure 3: Bahamas Net Foreign Investments (B$ Millions)



Source: Central Bank estimates.

Note: Total net FDI flows are shown on the right hand side; component changes are on the left. “Mortgage” refers to residential mortgages.

Figure 4 : Bahamas Monthly External Reserves Trends (B$ Million)



Source: Central Bank of The Bahamas.

Figure 5: Foreign Reserves Adequacy

Fig 5A: Import Reserve Cover (months)

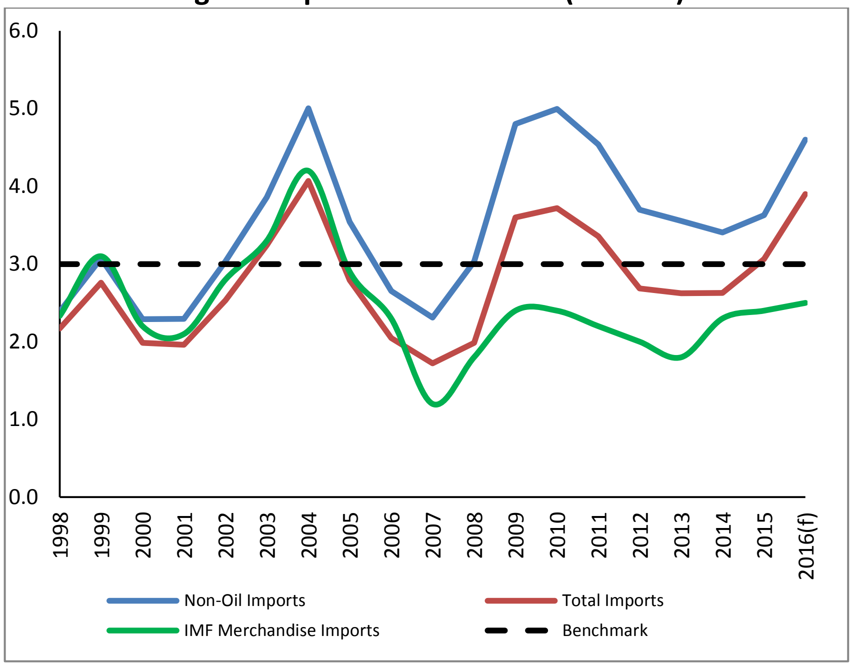
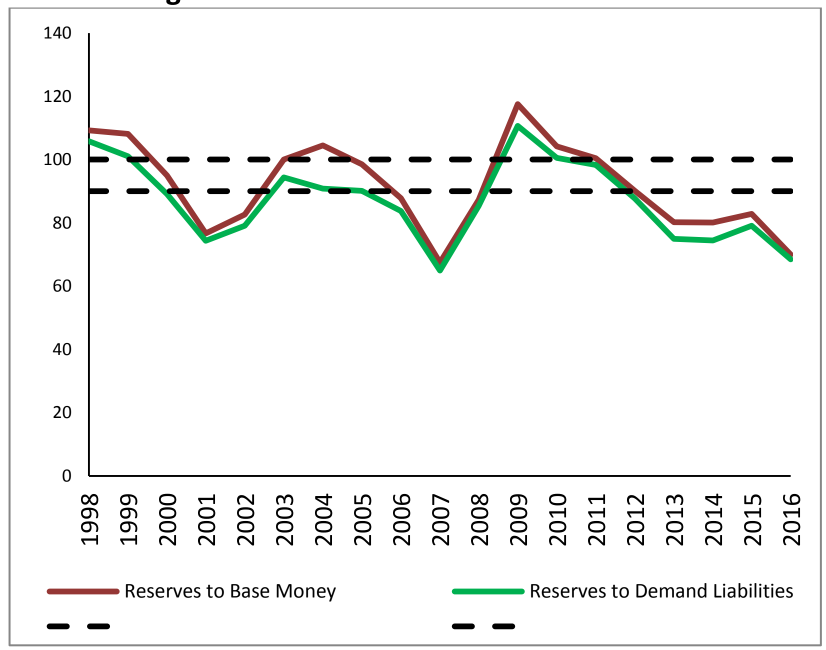


Fig 5B: Central Bank Balance Sheet Ratios



Sources: Central Bank and IMF estimates.

Note: IMF estimate uses current year's reserves as a fraction of projected total merchandise imports in the year ahead.

Source: Central Bank estimates.

Note: Base money comprises B$ currency issued by the Central Bank plus deposits of banks held at the central bank. Demand Liabilities consist of base money plus despots of government and other agencies held at the Central Bank.

Figure 6: Banking Sector Foreign Exchange (Forex) Flows (B$ Millions)

Fig 6A: Bank Forex Transations with Private Sector

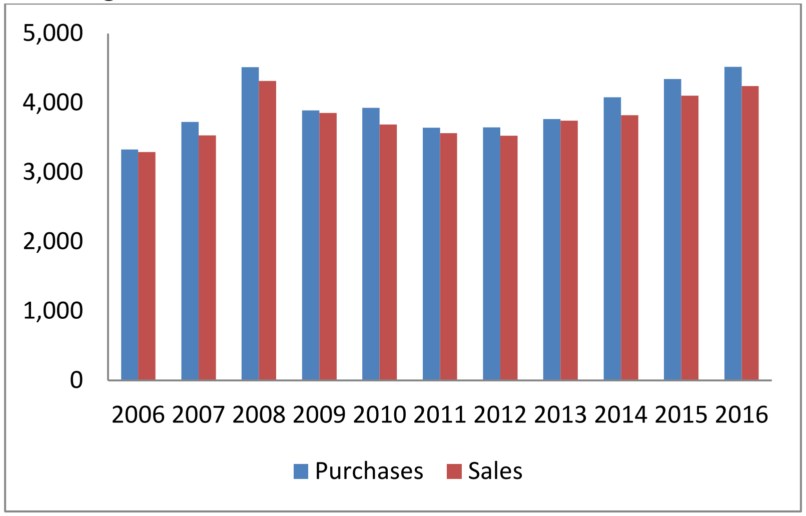


Fig6B: Central Bank Forex Transactions and Reserves

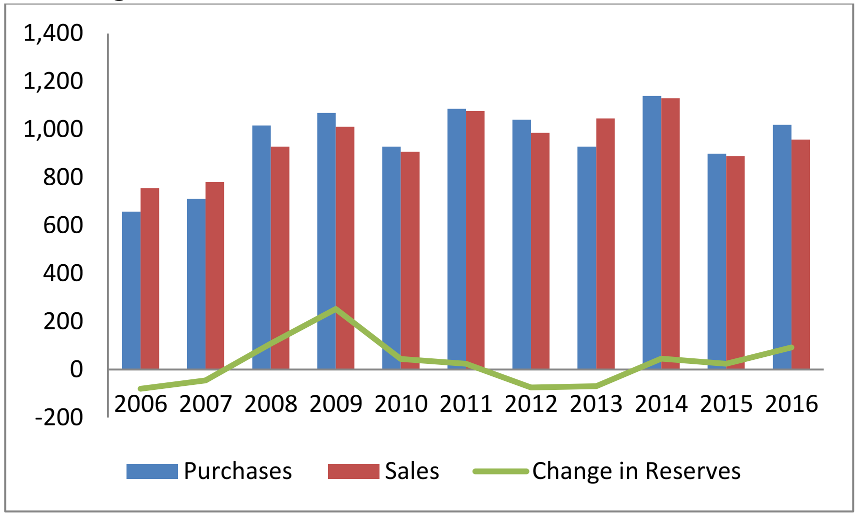


Fig 6C: Central Bank Forex Purchases

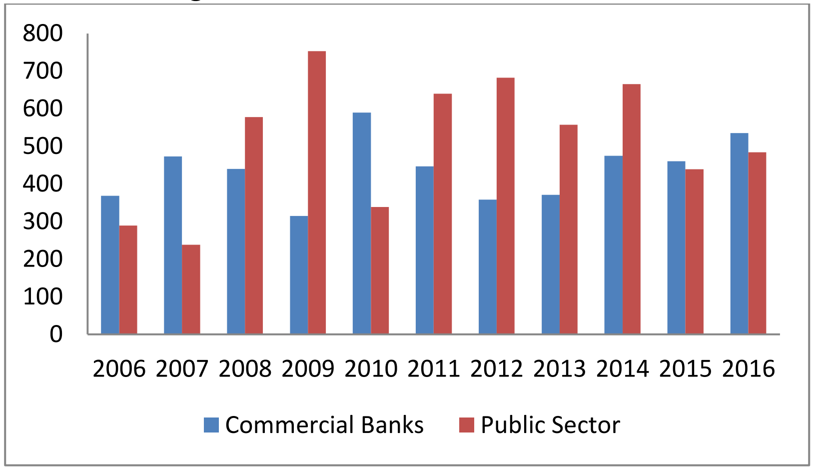
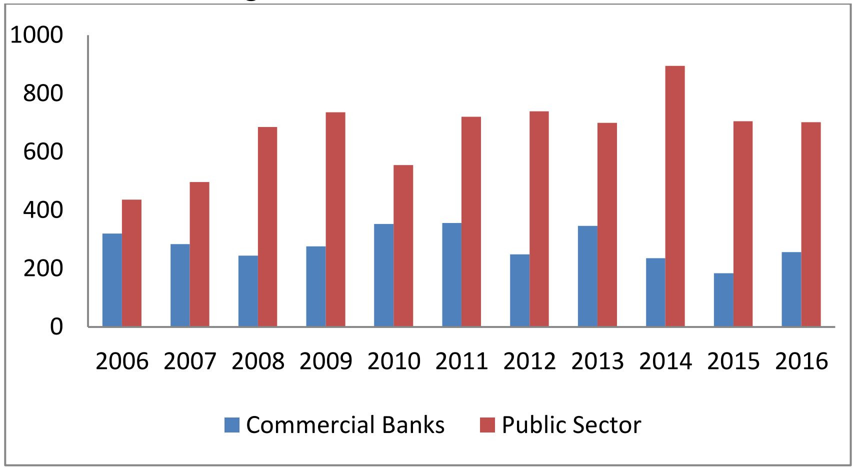


Fig 6D: Central Bank Forex Sales



Sources: Central Bank of The Bahamas