THE EVOLUTION OF EXCHANGE CONTROLS IN THE BAHAMAS

PRESENTATION BY GOVERNOR JOHN A. ROLLE*

THE ROTARY CLUB OF WEST NASSAU

WEST BAY STREET
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Good Afternoon:

Before I begin, would like to thank the Rotary Club of West Nassau and President Craig Butler for allowing me this opportunity to present the perspective of the Central Bank on evolution of Exchange Controls in the Bahamian context, and to share the Bank's ongoing plans for liberalization of the existing regime.

Introduction

Let me preface these remarks by explaining that The Bahamas is not ready for any total or outright removal of exchange controls, even though we should strive for greater liberalisation, supported by the right kinds of reforms within our financial systems, the legal and institutional frameworks around which we do business; and in national attitudes toward foreign ownership and foreign participation in the economy. Any sign of compromise in these areas would mean that we have to continue to adjust our views about where the Bahamas ought to end up in this process.

I hope that this presentation will give you some insights of how our current regime supports a stable currency, which remains fixed at one-to-one with the US dollar.

Our Economic Environment

The Bahamas is a small, very open economy, with a fixed exchange rate and heavily dependent on foreign trade. Each of these factors has contributed to the foreign currency arrangements that we have in place. Our Gross Domestic Product (GDP) is still less than $10 billion (IMF-2016 Article IV). Also imports make up an estimated 70-75% of everything we consume, and the oil bill is the largest single slice of these expenses.[1] Tourism is by far the largest source of foreign exchange.

The majority of our foreign trade has always been with the United States, which has justified keeping our two currencies totally aligned, since 1972, and virtually aligned for decades before that. We maintain this relationship by using the foreign currency reserves acting as a buffer. By law the reserves can never fall below 50 percent of the value of the B$ currency liabilities of the Central Bank.

[1] The local oil bill represented 16 % of the estimated goods imports for 2015, and a much greater share in years just before this, owing to the high price of oil.

Insights on the current Regime

The administration of the Exchange Control regime provides the Central Bank with the ability to manage net foreign currency flows through the economy, fully accommodate all trade or what we term current account transactions[2], and to restrict other flows to only accommodate certain kinds of financial and investment related transactions, though what we term the capital account.[3]

The current regime however has become more liberal over the years.

- Today Bahamians might only vaguely recall the practice of using the "dollar card", which was first the extent of liberation from over the counter Central Bank approvals, and only for credit card payments. The card lasted until 2006.
- In 1993 the trend of shifting certain approvals to commercial banks began. This, became more entrenched in further relaxations in 2006, 2010 and 2016.
- In 2006 the Bank also introduced significant capital account relaxation, particularly for residents to participate in and to finance investments overseas. This was expanded in 2016.

Capital account relaxation has also been a feature. Today the framework includes the following:

- Accommodation for regional cross-listing of securities both into and out of The Bahamas (2006). This is essentially an avenue for large public companies to raise capital throughout the Caribbean.

[2] Current transactions cover the normal goods and services produced and/or consumed. With very few exceptions, the Central Bank has removed all regulatory and bureaucratic formalities associated with Bahamians purchasing foreign currency for current account transactions purposes. Bahamians and non-Bahamian residents do not need Central Bank approval nor do they need to come to the Central Bank. Over the years, the Bank has devolved much of this responsibility to the commercial banks.

[3] A summary of the present treatment of current and capital account transactions can be found on the Bank's website: http://www.centralbankbahamas.com/exchange_regimes.php.

- A funding arrangement for Bahamas Dollar Depository Receipts (now for up to $35 million per annum for purchases of capital market investments outside The Bahamas).
- Cumulative access of up to $10 million per transaction, per group every three years for direct investments abroad. This facility is noteworthy because it allows individuals to acquire ownership in the international financial services sector and to invest in direct enterprise ownership in other countries.[4]
- Work permit holders have access to domestic securities and mortgage financing.
- The NIB has access to up to $25 million per year for external portfolio investments.

An investment currency market governs access to foreign currency for all other investment transactions.[5] The foreign currency has been sold in this market at a reduced premium of 12.5 percent since 2006, as opposed to what used to be a 25 percent premium.

As a general comment, neither the BDR facility nor outward direct investment privileges have been used as extensively as the Central Bank expected. Even the investment currency market is underutilized.

The area where The Bahamas sees most impact from the Exchange Control regime is for inward direct investments. Here there are important caveats however. The National Investment Policy has the strongest influence on how direct investments are channeled into this economy. Aside from the administrative these policies reflect preference for investments in the foreign exchange earning sector. The policies also reflect strong sensitivities about foreign ownership of real

[4] The qualifying criteria are that such investments have the capacity to generate income that can be repatriated to the Bahamas and boost foreign exchange earnings.

[5] The selling rate for investment currency, which can only be obtained through the Central Bank is B$1.125 = US$1.00 the central bank buys the repatriated capital at B$1.10. = US$1.00. All securities purchased with investment currency must be lodged in the custody of local trust company.

property in the Bahamas and protectionist views about which sectors should be exclusively reserved for Bahamian ownership. To discuss further liberalization about Exchange Control would require adjustments in some of these areas.

Caveats on Ambitious Liberalisation

It is in the area of investment flows, where much of the interest in liberalisation lies. At one end of the spectrum these would be longer-term support directly into businesses in the form of debt or equity. On the other end of the spectrum would short-term more liquid transactions such as deposits, maturing debt and capital market instruments.

In the extreme, a world without exchange controls where significant prominence would be given to short-term transaction would be one in which we would have to float the Bahamian dollar; one in which the Central Bank would still have to be active trying to manage the relative stability of the currency. Alternatively it could be a world in the currency is abandoned in favour of dollarisation and strong emphasis is placed on supervising the behavior of financial institutions to prevent costly crisis over indiscipline or excessively risky lending practices. Neither scenario would diminish the need for more active oversight of financial stability or accountability to some national regulatory authority. Indeed dollarisation would reduce the degrees of monetary policy independence that a country would have and rest more of the pressures on generating fiscal policies that are credible over the longer-term.[6]

[6] This does not make dollarisation an inferior option, if for the very small country it becomes more costly to maintain currency stability and manageable inflation in the flexible exchange rate arrangement

A liberalized exchange control environment, would be one in which investors vote with their capital, taking funds out of The Bahamas if confidence in economic, social or political policies weakens; and rushing to bring money into the country if confidence in these and other policy areas swell.

What would this mean for the financial environment?

Any large outflow of funds from the Bahamas would mean that persons involved are selling the local currency to buy foreign currency. That is, such as converting deposits, selling business and personal assets; selling stock and other portfolio investments. Unless the Central Bank operates with large stocks of foreign reserves, it would be expected that the only way to cope with such outflows would be to allow the currency to depreciate or fall in value (in other words to allow the price of the currency that is being sought after to rise in value). If confidence in the country improves and the opposite happens, a country, in the extreme, could be faced with an influx of funds that causes the value of the local currency to appreciate or rise in value.

Even if the population had unrestricted ability to move funds into and out of the country, the Central Bank would have an interest in keeping the exchange rate reasonably stable. If for no other reason, exchange rate stability matters for price stability. And price stability or better yet low to moderate inflation, matters for promoting for social wellbeing, for providing business with a less turbulent environment decision around long-term, investments and employment.

What kind of tools does one need for effective management of the exchange rate?

If a country does not have a large cushion of foreign reserves, it would lose the ability to intervene to keep the exchange rate stable. One alternative is that it could raise interest rates, within reason--unfortunately hurting business that rely on credit to finance their activities. If neither interest rate nor other intervention options existed then exchange rate would have to adjust a new equilibrium. Unfortunately, a lower value for the currency would translate into higher cost for imports, and therefore to higher inflation.

The conventional view is that if a currency is worth less the value, exports become cheaper and demand for the exports would increase -- which would be good for business. However, small countries like The Bahamas that lack the ability to set or vary the international price of their exports, and would normally face a price that is already established or quoted in a major foreign currency such as the US dollar. If the export is tourism, then recognizing that most of the inputs to the industry are imported directly or indirectly[7] would also mean little or no reduction in the price of the tourist product, from the perspective of the outside world.

In many countries, the large sudden outflow of capital[8] is often also a large withdrawal of bank deposits. Banks can fail from such experiences, if the deposits they need to return are tied up in longer-term credit that will only be repaid gradually.

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[7] Even if Labour were acknowledged as a local input, the main determinant of labour's wage demand would be the price of imported consumable goods, that would rise in the event of a currency appreciation.

[8] See the economic literature on Banking Crises, and sudden reversals of capital flows.

It is worth noting that having an influx of capital can also be a challenge. Either the currency could be allowed to appreciate or the central bank could purchase the excess inflows, and accumulate the funds in higher levels of external reserves. If the inflowing moneys are misused, it could mean again that banks and stocks markets become too exposed to potential collapse when investors take funds in the opposite direction in sudden fashion.

Developing Capacity for Liberalisation

How then does a country should position itself to benefit from more liberal movement in capital, while isolating itself from the downside risks of very liberal flows?

First it requires that the economy and policies evolve in a fashion that inspires longer-term confidence. That is, confidence of the nature that would not trigger sudden shifts in where moneys are invested.

Second, a country should also have the tools to manage the composition of the investment flows: whether this is in terms of what business opportunities residents or non-residents are able to take advantage of or whether the funds flow appear as highly liquid and mobile portfolio transactions or in longer-term direct investments. This is when capital or exchange controls start to take form. The capital flows that are more difficult to manage are those that are short-term in nature. They move quickly in and out. Examples would include deposits in bank accounts, and investments in stock markets (provided you can sell quickly).

One reaction that you might have is to suggest that the Bahamas should take a one-sided approach. That is, give nationals the unrestricted ability to invest outside in capital markets and bank deposits. However, this would mean that, unless the available foreign exchange was rationed, shortages could arise, and any hopes of maintaining a stable exchange rate would be lost. Unrestricted outflows would only make sense then if unrestricted inflows of capital are permitted, because these would help fund any outflow. The notion however that these movements would net out would be misplaced, unless there was no unsettling investor speculation around economic policies on balance. Again we would be left with having to tolerate some variability in the exchange rate.

I would argue that an unfettered liberalisation in the present environment would be undesirably disruptive. The economy nees to surmount significant competitiveness challenges, before being exposed in such fashion. This will only happen gradually.

Also, anticipating that the balance of short-term preference is for outflows on net, we would need to accumulate a much larger stock of external reserves, to keep the exchange rate within a stable zone[9]. This essentially requires movement along a path of growth that generates more net foreign exchange earnings and a cultural shift in attitudes towards more savings and less consumption. It also means a slower long-term trend in consumer credit growth, so that more of the foreign exchange earnings could be diverted to investments.

[9] By law the foreign currency backing for the Bahamian dollar cannot fall below 50 percent, and it has traditionally averaged less than 100 percent

It is also true that rationing of foreign exchange is not an optimal solution for the long-term. The incentives that the Central Bank will need to provide will have to be in terms of our ability to alter the returns that investors expect from moving portfolio funds into and out of the local currency. This for example, would include placing what would be termed "prudential constraints" on commercial banks' ability to deploy funds attracted from abroad. The Central Bank already has an array of tools, which could be expanded such as the reserve requirement on deposits, limits on mismatches between local currency assets and liabilities, and the ability to adjustable capital requirements to offset risky behavior.

Arriving to a point where the Central Bank is also able to have even stronger capacity to sterilise short-term capital movement is also important. Some of the reforms to modernize the Central Bank's legal framework could address this, by allowing the Bank to issue its own securities[10] to soak up excess liquidity that could be misused for unhealthy credit expansion. Once certain current innovations to the government securities market are complete, the Bank's ability to engage in repurchase operations in existing securities will afford similar opportunities.

Having more dynamic and deeper capital markets is also a requirement for channels of interventions to be more effective. As it stands, the local markets are still very illiquid, and require much greater volume of securities and participants. Some of the 2006 liberalisation initiative were targeted at the capital markets, and will require some tweaking in a further effort to develop the market.

[10] This would also expose the central bank to potential losses, from having to pay interest on such debt. The modernisation proposals therefore also address effective arrangements to recapitalise the Bank, in the event of large losses.

Pragmatic Policy Considerations

That said, there is no medium-term path, along which it is envisaged that exchange control liberalization would take us as far as to put the exchange rate into play. Hence there is still no justification path that would introduce the level of movement in short-term capital that comes to mind when some Bahamians speak about liberalization.

We do however see further significant room for purposely targeted liberalisation of capital flows, and would be prepared to formulate recommendations to the government along those lines—in stages. At the same time there is room for more aggressive liberalization of administrative policies, which recognizes that more delegated responsibilities can be given to commercial banks, backed by a greater focus on compliance and monitoring.

Today, the subject of allowing Bahamians business to borrow more freely abroad or take on non-Bahamian equity partners is raised frequently.[11] These touch on direct and indirect ownership issues that on a case by case basis are still mostly reserved for decisions by the Minister of Finance when the counterparty is not a Bahamas based commercial bank. When it is a commercial bank as foreign currency financier, the Central Bank can take the decision directly, and would limits its consideration to the foreign exchange earning potential of the borrower, and whether the borrower would have been be able raise the funding in Bahamian dollars.

[11] The distinction between secured credit or equity is not always material, secured creditors also become potential owners if the businesses default.

Any recommendations on liberalization on access to funding would therefore require greater authority within the Central Bank to approve certain financing, against very transparent criteria under delegation from the Minister of Finance, with flexibility that would have this responsibility shared with commercial banks under delegated authority.

I should add that while long-term investments could benefit move readily from more liberalisation. There is nothing in our current framework of consideration that would allow unfettered access of all sectors and all economic activities to foreign currency financing. There is also no consideration to easing access to foreign currency deposit accounts privileges, which would spark the kinds of exchange rate pressures that the Bahamas would wish to avoid.[12]

Our liberalisation proposals will therefore consider how greater indigenous private access to external financing can promote national development goals; how they can enhance our ability to earn or save on net foreign currency in the medium to longer-term and how they can help to fund activities that make the economy stronger in the long-term.

The following are some of the areas that come to mind:

- Health sector and education

[12] There is a school of thought that we should offer an amnesty to Bahamians who have assets broad to bring those back onshore and to allow them to retain them in foreign currency. However, much more though needs to be given to this, if the funds are not put to productive economic use, they would leave the financial system more vulnerable to crisis and risky lending practices. Nothing, in The Bahamas' regime prevents such assets from already being repatriated for direct investments.

- Energy conservation
- Tourism and linkages with the tourism sector (including commercial transportation)
- International financial services
- Development of the primary sectors (agriculture and fisheries)
- Other direct export activities

Move more cautiously on portfolio activity is consistent the views and advice that the IMF and other policy bodies would offer. That is, not proceeding with portfolio or short-term flows any faster than the pace at which the financial sector and central bank can mature to cope with these in a stable fashion. In fact the IMF recognizes that for some countries, pre-conditions for full capital account liberalization (that is for short-term flows) may never be satisfied.

Increasing Access to Direct Business Financing

In late October 2016, the Central Bank began its public outreach on liberalisation approaches by initiated a survey of the business community via the Chamber of Commerce, with several other professional associations, to gauge the current ease of access to business financing, and the appetite for such financing. The level of response to the survey has been underwhelming – much fewer than 100; but it has provided some helpful insights.

The responses represent a broad spectrum of small medium and large businesses including many in the wholesale and retail sector; some of the larger respondents already have approvals to obtain foreign currency financing given the nature of their activities. We are however keen to evaluate the responses from the small and medium sized businesses as these firms are the one that most often speak of consistent lack of access to financing given collateral requirements, the level of interest rates and other factors.

More data gathering will likely be required, and we would invite more of the business community to submit input. Nevertheless we are obligated now to formulate recommendations to the government for reforms that could take effect in 2017. Our recommendations will consider the role that local banks could play as well as non-bank channels of potential access.

It should be pointed out thought permission to access funding through alternative sources will not equate to success in securing funding in all cases. The inherent business plan risks will still dictate the attractiveness of proposals. Moreover, the expectation that funding will be at identical interest rates as advertised abroad should be tempered. The cost of funding and capital is inseparable from the risk of doing businesses within a country. A reasonable expectation is that there will be some premium on funding relative to the cost of US dollar funding for an business (equivalent in every other respect) in the US.

The Way Forward

Where does this leave us?

The Central Bank will work diligently to ensure that we continue to make progress on recommended, targeted easing of controls on capitals and to make significant improvements in the administrative processes. We will continue to build capacity to monitor foreign currency transactions and to manage the foreign reserves adequacy. We will continue to build capacity to monitor and manage capital transactions through less onerous process and are not planning any course of action that would place the stability of our currency at risk.

Our strategic plan for exchange control administration will target progress in the following areas:

- Investment in technology to automate more of the administrative processes
- Publication of detailed guidance notes to provide more transparency around exchange control administration
- Increased delegated responsibilities for commercial banks backed by improved systems of monitoring
- Review of the Investment Currency Market
- Further review of the current BDR regime
- More engaged public discussions on necessary reforms that would make the economy and financial sector more resilient to capital flows.

Constructive, informed dialogue on this topic, particularly in the context of goals that are being embraced in the National Development Plan, will be critical for the Bahamas going forward. I encourage you to provide input and to appreciate that this is a matter of national economic importance.