“The Bahamas’ Fixed Exchange Rate Regime: Can the Currency Peg Survive?”

Determining the Sustainability of the Fixed Exchange Rate

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Abstract

Since 1966, the Bahamian dollar has been pegged to the US dollar at a 1:1 value. Having a fixed peg relationship with a country, *also known as an "anchoring currency choice"* almost always comes with more trading between the two countries. *In the case of The Bahamas, the choice of the peg reflected geographic proximity, the already existing trade between the two countries and the desire for increased trade in tourism and investment.* This fixed exchange rate regime has served The Bahamas *very well and is generally believed to play a significant role in The Bahamas having the highest per capita income in the hemisphere, of any independent country, outside of the U.S and Canada.* The Bahamas *does not have a significant manufacturing base*, but rather offer services, namely in the tourism *and financial services sectors*. Having a 1:1 peg between BSD and USD encourages *this trade in services between the US and the Bahamas. In addition, the standing Peg serves to provide comfort and security to those looking to invest in the country and significantly boosts foreign direct investment.*

The problem today lies with whether or not a peg with the US dollar at a 1:1 basis is sustainable. Maintaining a fixed exchange rate can be very costly for the Bahamas *in that* a fixed exchange rate *restricts* the ability of the central bank from using monetary policy for stabilization by *limiting* its control of the domestic money supply. *Further, domestic fiscal policies must bear the brunt of any stabilization efforts.* If the Bahamas were to lose this *fixed exchange rate parity*, *either through a devaluation or conversion to a floating exchange rate regime*, the Bahamian dollar would be less valuable in the global economy and would negatively impact the purchasing power of consumers and *potentially reduce foreign direct investment*. This paper will address the advantages and disadvantages of having a fixed exchange rate as well as how economic shocks impact decisions regarding the peg. This paper will also address what would happen if the Bahamas were unable to maintain the fixed exchange rate.

Key words: Fixed exchange rate regime, peg, monetary policy

Table of Contents:

1. Introduction

According to the Department of Statistics, in 1966, the Gross domestic product (GDP) for the Bahamas was roughly $0.34 billion. As of end-2019, GDP stood at $13.58 billion of which 50% is attributed directly to tourism and a further 15% to financial services. Two-thirds of all employment in the Bahamas can be attributed to tourism both directly and indirectly. Approximately 90% of all visitors to The Bahamas come from the North America of which about 80% come from the USA. Similarly, the World Bank has reported, in 1966 the Bahamas GDP per capita was 2,322.690 USD, compared to Jamaica's which was 615.966 USD. Comparing this to the 2019 data, The Bahamas has a GDP per capita of 34,863.742 USD whereas Jamaica has a GDP per capita of 5,582.264 USD. Barbados GDP per capita was 2,616.89 in 1974 and has increased to about 36,296.49 as of 2019. While obviously not all of this can be attributed to the fixed exchange rate regime, the data certainly helps the case of a fixed exchange rate regime for the Bahamas by contrasting the economic positions of these two countries.

The Bahamas has had its currency pegged to the US dollar since 1966. According to the central bank of the Bahamas, the primary reason for the peg is for trading purposes. Since the main trading partner of the Bahamas is the United States, the country decided to peg its currency to the US dollar rather than the British pound. This decision also makes sense from a geographic standpoint, considering that the United States is significantly closer to the Bahamas than Britain.

Many countries have had their currency pegged to the U.S. dollar. After World War II, in an effort to help rebuild the international economic system, the Bretton Woods system was introduced. Bretton Woods was an agreement between 44 allied nations to peg their currency to the U.S. dollar which was pegged to the price of gold. Notable countries involved in this agreement were the United States, Canada, United Kingdom, Soviet Union, Australia, and Japan.

As countries started to lift exchange controls and deregulating financial markets, weaker currencies became more vulnerable to changes in global capital flows, and it became near impossible for the Bretton Woods system to operate as an adjustable peg system. Currencies apart of the Bretton Woods system became subject to speculative attacks. Thus, the Bretton Woods system lasted from the mid-1940s to the early 1970s. [Obstfeld & Rogoff 1995]

To defend a currency peg against a speculative attack, the central bank needs to have enough resources to buy back the monetary base which includes deposits at the central bank plus currency. However, in practice the central bank can instead raise interest rates to a level that will deter speculators with the added expense. These sharp spikes in interest rates if maintained for a long period of time, can cause major damage to the banking system. The negative effects of these unanticipated sharp spikes in interest rates include harm to investments, unemployment, the government budget deficit, and the domestic distribution of income. Attempting to fix the exchange rate in the face of volatile expectations can lead to drastic changes in interest rates reserves and ultimately, to serious ruptures in policy credibility. [Obstfeld & Rogoff 1995]

Richard N. Cooper states "There is the by now well-known trilemma, whereby a country cannot simultaneously maintain a fixed exchange rate, freedom of capital movements, and an independent monetary policy. With a fixed exchange rate and free cross--border movement of capital, the country's monetary policy will be determined by monetary conditions outside the country." This is the situation that in which the Bahamas currently faces. While fixed exchange rates are very useful for the Bahamas, it also forces the country to keep a keen eye on what is happening in the U.S. economy to keep the value of the Bahamian dollar in line with the U.S. dollar.

Both fixed and flexible exchange rates create problems for countries. If the country decides to have a flexible exchange rate, it allows the currency to depreciate which will lead to currency mismatches and bankruptcies. However, if the country decides to have a fixed exchange rate, it will need to defend its peg by selling reserves and raising interest rates. This will then precipitate defaults on short-term domestic debts. [Eichengreen, B., & Hausmann, R. (1999)]

In the paper *the mirage of fixed exchange rates*, the authors argue that fixed exchange rates are extremely difficult to maintain and that most countries cannot sustain them. However, the conclusion of the paper also notes that in a few cases specifically in tourist economies, oil sheikdoms and heavily dependent principalities, fixed exchange rates can work. Since the Bahamas has an economy that is heavily influenced by tourism, it can be argued that the Bahamas is one of the few countries who have the ability to maintain a fixed exchange rate regime for a long period of time. While this study argues against fixed exchange rates for most countries, it is important to remember that decisions regarding monetary policy and exchange rates need to be catered to the country at hand.

The Bahamas has been able to maintain this fixed exchange rate regime for over 50 years. This gives one reason to believe that the Bahamas has the ability to sustain this rate for an even longer period of time. Examining circumstances that have occurred in the Bahamas economically in the past 50 years, there are several events that would have threatened the Bahamas economy as well as the fixed exchange rate regime. Specifically, events such as natural disasters of the past. The Bahamas has suffered and survived numerous destructive hurricanes.

A lot of Caribbean countries have had their currencies pegged to the U.S. dollar in the past, Jamaica, Trinidad, Guyana, Barbados and the Eastern Caribbean Currency Union. This paper will look at Jamaica and Trinidad and Tobago in particular. They both have had their currencies pegged since the early 1970s. However, they also both switched from a traditional fixed exchange rate regime to floating exchange rate regime or a “managed float”. Jamaica made this switch in 1991 and Trinidad Tobago shortly after in 1993. According to a study on interest rate determination in developing countries, the real interest rate is constant for the Bahamas and Barbados, but not for Jamaica or Trinidad and Tobago. [Lorde, T., Francis, B., Waithe, K., & Taylor, T. G. (2008)]

Unlike Jamaica or Trinidad and Tobago, both The Bahamas and Barbados have maintained their currency peg to the U.S. dollar. Looking at similarities between Barbados and Bahamas, they both have their currency hard pegged with a fixed nominal exchange rate to the U.S. dollar since the early 1970s. They are also both highly dependent on tourism. With these two factors, the results of The Bahamas and Barbados seem to be consistent with the U.S. Inflation in the Bahamas and Barbados also seem to depend heavily on external inflation (U.S. CPI or real exchange rate). Evidence suggests that nominal interest rates in the Bahamas move at a one-for-one rate with the US nominal interest rate. [Minella, A., Powell, A., Rebucci, A., & Souza-Sobrinho, N. F. (2009)]

One of the goals of the central bank is to maintain an external value of the Bahamian dollar. Having a fixed exchange rate between BSD and USD has played an important role in maintaining the external value of the Bahamian dollar. It has allowed for the ease of travel for American tourists who do not have to exchange any American dollars for Bahamian dollars because they are valued at a 1:1 basis and American dollars are accepted as legal tender in the Bahamas.

While having a floating or flexible exchange rate would allow more freedom as to monetary policy, these methods also come with other expenses. For example, Jamaica and Trinidad and Tobago still have the need to actively intervene in the foreign exchange market in an attempt to maintain the stability of their currencies with the US dollar. [Lorde, T., Francis, B., Waithe, K., & Taylor, T. G. (2008)]

According to John Grieve Smith, the major weakness of the fixed exchange rate system is the difficulty of adjusting rates when relative costs in different countries get out of line. This was demonstrated in the collapse of the Bretton Woods system where these adjustments were delayed. These overdue delays were eventually forced on the country by a run on its currency and consequently devalued the currency. This same problem with fixed exchange rates applies today to currencies that are pegged to other major currencies. The consequence of moving towards a more stable system of managed exchange rates is that countries would no longer be able to freely use monetary policy as the prime mean of managing demand. [Smith, J. G. (2002)]

From an industry point of view, exchange rates should be both competitive and stable. The floating exchange rate does neither.

2. Literature Review

a. Cost of Maintaining the Peg

The Bahamas has endured over 55 hurricanes since the 20th century, 13 of which were high intensity. Hurricane Andrew was one of these, it occurred in August of 1992 and cost the Bahamas over 250 million dollars in damage. It is important to note that hurricane Andrew mainly impact family islands such as Eleuthera and Cat Island. If a natural disaster this large impacted New Providence directly, the economic damage would have been significantly more catastrophic. Looking at the Bahamas' most recent natural disaster, hurricane Dorian caused major damages to Abaco and Grand Bahama in 2019. It is estimated that hurricane Dorian is responsible for 3.4 billion dollars in damages and losses. At the time this was equivalent to a quarter of the Bahamas' GDP. [Zegarra, M. A., Schmid, J. P., Palomino, L., & Seminario, B. (2020)]

While a country has to give up a lot to maintain a fixed exchange rates, for some countries these tradeoffs are worth it. Without a fixed exchange rates, a countries currency would be extremely vulnerable to the unpredictable volatility of exchange rates in the global market. Many economists believe that this uncertainty of exchange rate leads to less international trade and discourages investment. Another reason for maintaining fixed exchange rates is to help restrain domestic inflationary pressures. By pegging to a low-inflationary currency, the government is better able to resist excessively expansionary macroeconomic policies. [Obstfeld, M., & Rogoff, K. (1995)]

Fixed exchange rate regimes are difficult to maintain, only a handful of countries have been able to maintain a tightly fixed peg to any currency for over 5 years. According to Worldometer, there are 195 countries, of which 193 are member states of the United Nations. According to Investopedia, 38 countries have exchange rate agreements with the United States and 14 have currencies pegged to the USD.

It is important for the monetary policy framework keeps inflation expectations anchored and minimizes unnecessary fluctuations of economic activity. According to the traditional theory, having a fixed exchange rate with free capital flow can help reduce economic volatility stemming from economic shocks. However, fixed exchange rates can increase volatility stemming from real shocks. If the peg is perceived as reliable, fixed exchange rate regimes can increase the credibility of monetary policy.

In a study done, all five of the countries that followed a fixed exchange rate regime were able to maintain a stable nominal exchange rate through 2008. To defend against this global crisis, many central banks with both fixed and flexible exchange rates sold foreign currency to contain exchange rate pressures. Of the seven Caribbean countries included in this study, The Bahamas had the highest GDP per capita. [Minella, A., Powell, A., Rebucci, A., & Souza-Sobrinho, N. F. (2009)]

According to Yagci, F. (2001), “For any exchange rate to maintain a stable and competitive real exchange rate requires a supportive policy environment which would include prudent macroeconomic policies, a strong financial sector, and credible institutions.” Yagci also notes that monetary policy should be consistent with exchange rate objectives. “Overvaluation of the real exchange rate is strongly correlated to unsustainable balance of payments deficits, currency crisis, and low economic growth.”

[Conclude Literature Review] According to [Klein, M. W., & Shambaugh, J. C. (2006)] “results from estimating gravity models imply that fixed exchange rates have a statistically significant and economically important role in influencing trade.” Many economists agree with this statement. The existence of a credible fixed exchange rate regime has a positive impact on bilateral trade. Fritz-Krockow also notes that the longer a fixed peg has remained in place, the more it benefits from trades. [Fritz-Krockow, B., & Jurzyk, E. M. (2004)]

3. Methodology

   a. Conditions Supporting a Peg

One of the primary conditions supporting a peg is the relationship between the country with the fixed exchange rate regime, and the anchor currency. For the Bahamas, this would mean a sustainable political and economic relationship with the United States. This paper looks at trading statistics to determine that a country has a good economic relationship with another country. Much like the Bahamas, the economy of Barbados is extremely dependent on the country’s relationship with the United States. In 1970, Barbados exported approximately $14.9 million USD worth of goods to the United States. Comparing this number to 2019, Barbados exported about $93 million USD worth of goods to the United States. This accounted for about

20.86% of Barbados total exports in 2019. Imports from the US to Barbados have also increased significantly since 1970. Between 1970 and 1984, imports from the U.S. went from $49.3 million to 635.9 million. Barbados imports have fluctuated since then, but in 2019 Barbados imported about $595 million from the US. This accounted for 37.61% of Barbados total imports in 2019.

In 1960, 48.9% of Barbados imported goods were from Europe, and only 13.1% were from the US. These numbers have shifted over the years, as of 1980, the US was responsible for 34% of the imports compared to 20.3% from Europe. It can be argued that the fixed exchange rate is responsible for this shift from Europe based trading to US based trading. Having a fixed exchange rate with the US helps both the Bahamas and Barbados capitalize on being located geographically close to the US.

Bermuda has maintained a fixed exchange rate with the US dollar since 1972. Much like the Bahamas, Bermuda's currency is pegged to the US dollar at par value. In 2019, Bermuda exports totaled $27 million. Of which, $21 million (78.3%) was exported to the United States. During 2019, Bermuda imported about 1.118 billion USD worth of goods. Of these imports, $795 million were imported from the United States. This data shows that approximately 71.12% of all Bermudas imports in 2019 were from the United States.

Belize has maintained a fixed exchange rate with the US dollar since 1976. Like Barbados, Belize is pegged to the US dollar at a 2:1 basis. In 2019, Belize exports totaled $245 million. Of which, $62 million (25.4%) was exported to the United States. The majority of Belize's exports went to the United Kingdom totaling $82 million (33.5%). During 2019, Belize imported about $986 million worth of goods. Of these imports, $436 million (44.2%) were from the United States. The United Kingdom did not account for any significant portion of Belize's imports (less than 3%).

According to the Bahamas Department of Statistics, in 2019 the Bahamas had $537.3 million in exports and $3,320.5 million in imports. The United States was responsible for $2.7 billion in exports. This makes up approximately 81.3% of the Bahamas total imports in 2019. The United States is also responsible for $474.3 million of the Bahamas' exports (88.3%).

[Another country that has maintained a fixed exchange rate with the US and also have maintained a stable relationship with US/anchor currency] [The tourist industry contributions of GDP to these 3 countries]

Guyana pegged their currency to the US dollar in 1975. (Give an example of a country that lost their fixed exchange rate with the US because of unstable economic and political situations and their relationship with the anchor currency.) (How many political party changes has the Bahamas had since 1966)

ECCB (good data) Belize (Bermuda grey area because of UK ties)

i. Stable relationship (economic and political) with anchor currency

For a country to maintain a fixed exchange rate, they must have a stable political environment. The Bahamas has been a stable political environment since its existence. The Bahamas is a democratic nation and has elections every 5 years. Much like the US, The Bahamas is a market-based economy.

In 1985, Desmond Hoyte became President of Guyana. Hoyte intended to speed up the pursuit of socialist construction. After a year of being unsuccessful in repairing Guyana's economy, Hoyte ordered a cut on public spending and encouraged foreign investment. In 1983 the International Monetary Fund (IMF) curtailed all further lending to Guyana, since payment on loans were long overdue. In 1985, the IMF declared Guyana as ineligible for further credit and loans (1985-1992) In 1988, Guyana's payment of arrears was more than $885 million USD, which was about quadruple the country's annual exports.

The country began reintroducing a pro-capitalist market economy. After a few years, Hoyte departed from cooperative socialism and began negotiations with the IMF to which then made arrangements with the World Bank for an Economic Recovery Program (ERP). This program was to be carried out in 3 phases, stabilization, rehabilitation, and recovery and growth. The stabilization phase included an initial 70% devaluation of the Guyanese currency. Guyana had began a steady devaluation of its currency to match the official exchange rate with the market rate. From 1989 to 1991, the exchange rate slid 250% annually. In 1991, Guyana opted for a floating exchange rate with the US dollar and to have that rate settled by market forces. The mid-year rate for 1991 was $125 Guyanese dollars to $1 US dollar.

The results of the ERP were not good. The World Bank and IMF had predicted a 5% increase in real GDP in 1989, instead there was a 5% deficit. Guyana's budget deficit increased from 17% of GDP in 1980 to 59% of GDP in 1985. The penalties for the devaluation of Guyana's currency were massive. In 1991, more than 60% of the country was living below the poverty line.

ii. Stable domestic economic environment

1. **No excess FX government/quasi-government or private sector debt**
2. **Examine External Debt to GDP ratio**

Examine countries with stable political environments (The Bahamas and the US have both been stable political environments since they have both been Democratic Market Based Economies.

% of total imports	% of total exports	Year

84%	72%	2006
87%	71%	2007
87%	69%	2008
87.4%	71.3%	2009
83.8%	75.6%	2010
82%	78%	2011
76.5%	81.5%	2012
81.8%	83.6%	2013
79.3%	82.7%	2014
81.6%	82.3%	2015
82.1%	82.8%	2016
81%	79.3%	2017
83.7%	70.9%	2018
81.3%	88.3%	2019

The Bahamas trading relationship with the United States has remained consistent throughout the years. With the US being The Bahamas' primary importer and exporter. This high level of trade is encouraged by the fixed exchange rate and is a large reason why the Bahamas has worked hard to maintain the fixed exchange rate.

Belize – U.S. based stay over tourists

2008	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**
63.5 %	63.8 %	64.6 %	66.2 %	63.3 %	63.0 %	64.6 %	65.8 %	68.7 %	68.0 %	67.7 %	67.4 %

External Debt to GDP ratio

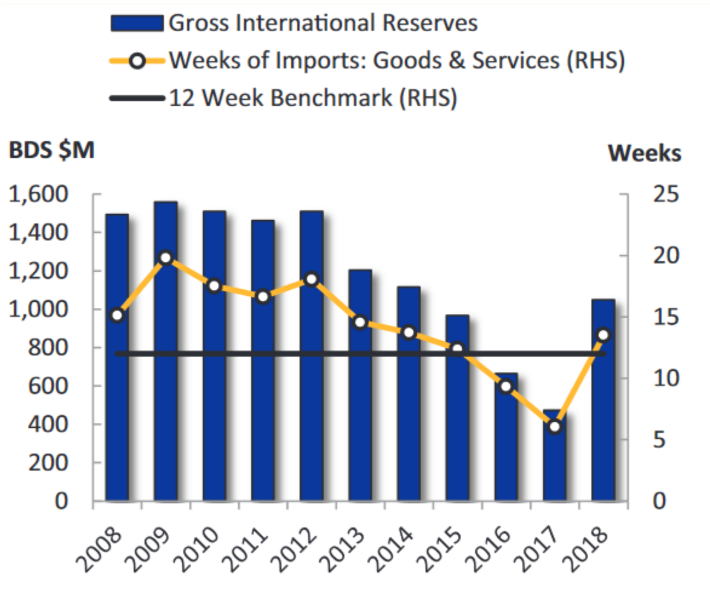
Bahamas	Barbados	Belize	Guyana	Year
39.9%	144.4% (estimate)	84.8%	24.1%	2020
24.7%	120.2%	69.9%	31.6%	2019
24.9%	126.3%	68.6%	33.9%	2018
27.8%	148.4%	68.4%	34.3%	2017
26.2%	151.2%	67.8%	34.0%	2016
24.8%	144.2%	68.3%	36.1%	2015
23.8%	137.0%	67.7%	39.5%	2014
19.2%	131.5%	67.3%	41.8%	2013
17.8%	119.8%	64.4%	48.0%	2012
13.2%		68.6%		2011
11.9%		72.3%		2010
9.8%		75.9%		2009
5.4%		69.8%		2008
4.5%		75.4%		2007
4.6%		81.0%		2006

*For Barbados we used Gross Public Sector Debt (% of GDP)

In 2000, Guyana's external debt as a percentage of GDP was 169.6%. It is important to note that in 2006 Guyana received debt write-off under the Multilateral Debt Relief Initiative from the IMF and the International Development of the world bank.

Barbados receives 35% of its tourist from the UK and 25% from the US. It is also important to note that Barbados currency is pegged to the US dollar at a 2:1 basis. Looking at the data, it is clear to see that Barbados has been struggling with a debt problem for some time. In June 2018, in response to worsening fiscal and external liquidity issues, the government of Barbados implemented Barbados Economic Recovery and Transformation (BERT). This plan aimed at macroeconomic stability while also maintaining the financial and social sectors. The BERT plan suspended payments due on debt owed to external commercial creditors as well as both domestic and external debt restructuring. The goal is to reduce the debt to GDP to 60% by 2033. They have so far been following the program, as in both 2019 and for part of 2020 they achieved a target GDP surplus of 6.1%. March 2020, gross central government debt declined to 117.4% of GDP. However, Covid-19 negatively affected a lot of economies to which Barbados is no exception.

Due to the debt restructuring, Barbados can no longer use market-based financing as a means of funding the economy. Instead, Barbados does finance through the Caribbean Development Bank (CDB) and the Inter-American Development Bank (IADB). The government of Barbados also receives support payments from the IMF. Barbados main way of achieving revenue is through taxing methods. Value Added Tax (VAT) contributes 32% of total revenue and a combination of personal income tax, corporation tax and estate tax contribute 33% of total revenue. Import duties contribute 8% of total revenue.



Source: Central Bank of Barbados

The Central Bank of Barbados has been aware of the economic struggles they have been dealing with in recent years. In the 2017 annual report, it is noted that inflationary pressures and low level of investments "dampened the acceleration of the economy." In the 2018 annual report, the governor notes problems that need addressing include public sector debt and falling international reserves. Taking on excessive amounts of external debt forced Barbados to use up a lot of their international reserves in order to pay off the debt. Barbados' international reserves had been decreasing since 2012 and got very low in 2017. These rapidly falling reserves are a large reason for the creation of BERT. BERT is responsible for the jump of reserves in 2018.

Could this massive amount of debt been avoided if Barbados decided to release the peg? They would have been able to utilize their monetary policy freely in order to potential soften the blow of these economic difficulties.

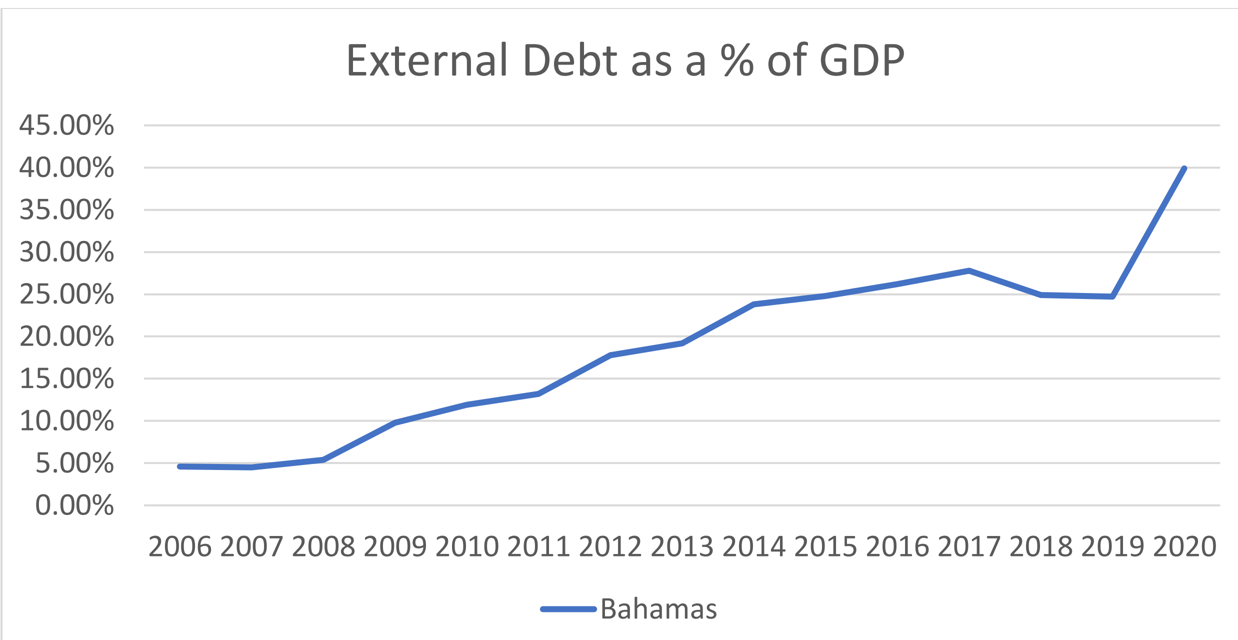
According to Saxegaard, Guyana's debt problem begins with the oil crisis in the 1970s. When rising oil prices negatively affected the balance of payments, Guyana began to borrow excessively. By 1995 Guyana became one of the most indebted countries, having an external debt exceeding $2 billion. With the external debt more than tripling GDP. [Saxegaard, M. (2004)]

Guyana no longer has its currency pegged to the USD, rather uses a floating exchange rate. Since then, Guyana's external debt to GDP ratio has improved greatly and is continuing to improve. While this ratio has improved, it is still important to note that giving up the fixed exchange rate went very poorly for Guyana. Guyana did not have a stable political environment, nor a stable domestic economy.

Out of these countries, the data seems to point to the fact that the Bahamas has the best relationship with the United States. Not only is the US the primary trading partner of the Bahamas, but for several decades 80% of the Bahamas tourists have originated from the US. Comparing this to Barbados who has consistently received less than 40% of their tourists from the US. Belize also receives the majority of its tourists from the United States having about two-thirds of their stay over tourists originating from the US. 2020 was a difficult year for a lot of countries, but tourist-based economies suffered heavily since most travel was restricted.

These countries need to go into such excessive external debt in order to maintain a proper amount of foreign reserves to defend a fixed peg. Right now, the data shows the Bahamas is currently in a more favourable economic position with regard to debt than the other countries analyzed in this paper. However, there is still reason to keep a keen eye of concern. The data also shows that the Bahamas' external debt as a percentage of GDP has been steadily increasing over the past several years. If the Bahamas keeps in this direction, it is possible that the Bahamas will end up in the same position as Barbados or Guyana at some point in the future. When countries with fixed pegs have economic troubles, what usually happens is they to go into excessive debt to defend its peg and despite the excessive debt, end up having to remove the fixed peg entirely. While taking on excessive debt has delayed removal of the peg, it usually does not prevent it. Sometimes countries have been forced to remove their peg due to the excessive amount of debt.

[What can we do other than take on external debt to maintain the peg]



Between 2019 and 2020, the Bahamas' external debt as a percentage of GDP has increased by about 15%. This increase was abnormal compared to previous years but is in line when comparing the other countries studied for 2020. This is not abnormal when comparing this ratio to the other countries in 2020. Barbados had a 119.8% external debt to GDP ratio in 2012, and this ratio continued to increase to 151.2% in 2016 and 148.4% in 2017. After receiving help through Barbados Economic Recovery and Transformation (BERT), they began to lower this ratio until 2020 brought it back up to 144.4%. Belize also experienced this jump in 2020. After maintaining around 67% external debt to GDP, this ratio jumped to 84.8% in 2020.

While many countries experienced this increase in external debt as a percentage of GDP in 2020, there is still some need of concern for the Bahamas. This increase should not be fully attributed to maintaining a fixed exchange rate, but rather to the suffering of the global economy and specifically tourist-based economies.

While the Bahamas' external debt as a percentage of GDP increased, it is important to note that external reserves grew by $624.1 million to $2,382.2 million. Compared to 2019, the Bahamas had a 35.5% increase in ending external reserves. This increase was largely due to net public sector debt proceeds. Not only did Covid-19 impact the need for these public sector debt proceeds, but insurance claims from the effects of Hurricane Dorian continued through the first quarter of 2020. National debt to GDP ratio also increased drastically in 2020 from 62.3% to 87.7%. As expected, external debt increased largely as well in 2020 from $3,123.1 million to $4,477.8 million.

The Bahamas' profitability was severely damaged during 2020. Return on equity (ROE) dropped 11% from 2019, from 10.7% to -0.3%. Return on assets (ROA) also experienced a decrease from 2.4% to -0.1%.

The Bahamas' tourism industry took an astronomically large hit in 2020. According to the Bahamas Department of Statistics, the Bahamas had a total of 451,736 stopover visitors of these visitors, 364,973 (80.8%) were US residents. In 2019, total stopover visitors were 1,806,674 of which 1,473,279 (81.5%) were US residents. This was the highest number of tourists and US based tourists the Bahamas had ever seen. In 2020 the Bahamas only had a quarter of the stopover visitors when compared to 2019. A drop-off this large to the Bahamas' most important industry was sure to wreak havoc on the economy. Given the circumstances it is no wonder that the Bahamas external debt as a percentage of GDP increased 15%.

The government must ensure that expenditures are not excessive. In order to maintain the ability to use fiscal policy as a means of stabilization. Since monetary policy cannot be used for stabilization purposes, the government is forced to use fiscal means such as raising taxes or lowering expenditures. If a political party comes into power that wants to accumulate a lot of debt and create a lot of expenditures, their will be a strain on the sustainability of the fixed exchange rate. If for some reason the Bahamas relationship with the US deteriorates, and trading begins to slow down, this would lead to an even greater strain on the sustainability of the peg.

4. Cost of Maintaining the Peg vs Cost of Exiting the Peg

i. What can we do other than take on external debt to maintain the peg?

Looking at the problem of external debt and fixed exchange rates begs the question, what can be done other than taking on external debt to maintain the peg. To maintain a fixed peg, a country needs to maintain an appropriate level of foreign currency. A country can do this through external debt, or they can achieve it through boosting foreign direct investment. As with most decisions, there are pros and cons to consider.

While boosting foreign direct investment will increase foreign currency inflows to a country, it also has its fair share of down sides. To boost foreign direct investments, the Bahamas would need to divert more of its resources to developing these sources. The country must also review and agree to Heads of Agreements and dedicate the resources to monitor adherence of those agreements. By obtaining more foreign direct investment, the country is simultaneously giving foreigners greater access to domestic resources. This in turn puts a larger portion of the Bahamas economy into the hands of non-Bahamians. This leads to a loss of sovereignty and increases the country's dependence on foreign capital to maintain a similar standard of living. While foreign direct investment isn't the same as external debt, there is still pressure on future foreign currency assets in order to repay the investment in forms of interest, dividends and capital.

The only alternative to taking on external debt and foreign direct investment would be to exit the peg. There are two different ways a country can exit a peg, it can be either involuntary through pressure or, a voluntary exit of the peg. Exiting the peg under pressure usually results in the most economically disastrous situation. In the past, countries have attempted to defend their peg through central bank intervention. This almost never works in the long-run and results in the central bank being depleted of foreign reserves and taking on unreasonable amounts of debt. This is the most unfortunate outcome, because the Bahamas would lose the peg and have no real control over it.

Exiting the peg voluntarily would give a better result than exiting the peg involuntarily but is still not a desirable outcome. This would result in a depletion of foreign reserves, which may lead to further involuntary depreciation. Losing the peg would result in an inability to maintain the standard of living that the Bahamas is used to. We would have to reduce our consumption patterns in proportion with the reduction of imports. Not only are there significant economic consequences, having been able to maintain this relationship for so long and losing it may damage national pride. Losing the peg would cause severe reputational damage as well as investment uncertainty. Foreign investors will be less likely to invest in a country when they won't be getting a stable value back.

After examining these three options, it appears to me that maintaining the peg through a careful mixture of external debt and foreign direct investment will result in the best outcome for the Bahamas. While external debt and foreign direct investment have their downsides, it is better to do what we can to maintain the peg rather than exiting the peg. Losing the peg could result in immense damage to the Bahamas' economy.

While the fixed peg takes a lot of work to maintain, it is worth the expenses it takes to maintain it. I believe the peg is sustainable as long as the country continues to make sacrifices to maintain it. I believe that maintaining this fixed exchange rate regime should be a priority for the Bahamas as much of the economy relies heavily on the country's relationship with the US, both through trading as well as tourism.

I believe that the Bahamas has the ability to maintain the fixed exchange rate regime. Considering the fact that tourism is by far our largest industry, being able to reliably exchange the currency on a 1:1 basis is crucial to our relationship with the US. With so many US tourists visiting our country, there is a constant inflow of the US dollar into our country and we are able to maintain an appropriate amount of foreign reserves. Many tourists from the US enjoy the simplicity of being able to use their currency rather than having to worry about a fluctuating exchange rate.

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