"What Our Future Holds":

Addressing Inflationary Pressures in The Bahamas

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Author Note

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Abstract

Over the past 55 years, the inflation rate in The Bahamas has fluctuated (the average inflation rate as of 2021 was 4.1% (Worlddata.info, 2022). Inflation reduces purchasing power or the amount of something that can be bought with money, and high inflation accelerates this phenomenon. In contrast, some economists believe that a modest amount of inflation can assist the economy's growth (Warr, 2019). In 2020, the pandemic had an extremely negative impact on the global supply chain, which impacted inflation rates. By April 2022 in an interview, Prime Minister Philip Davis stated that the recent factors impacting inflation are out of the control of the government, essentially conceding that there is not much that can be done. Inflation impacts can be observed in manufacturing and transportation cost increases, labor shortages, the automobile sector, and materials/products that originate from China. Additionally, the recent invasion of Ukraine by Russian forces has further exacerbated the rate of global inflation, with no signs of slowing down any time soon.

This paper aims to determine how inflation impacts Bahamian society, specifically focusing on the construction industry. Furthermore, it will highlight how other countries have, and continue to combat inflationary pressures, with hopes of finding methods The Bahamas can implement to soften the blow and its impact on the economy.

Keywords: Inflation, Construction, Bahamas, Inflationary Pressures

Introduction

The world at large is experiencing increased prices, which can be attributed to several factors. One of these factors is the COVID-19 pandemic, which has resulted in a recession. Additionally, the recession has been exacerbated by the conflict in Ukraine, which is disrupting global trade and investment, harming European automakers, hoteliers in Georgia and the Maldives, as well as global food and fuel consumers (Ruta, 2022). The spike in prices worldwide has served to accelerate global inflation, and these prices have caused inflationary pressures in The Bahamas.

Inflation leads to the gradual loss of a currency's buying value over time (Investopedia.com, 2022). The increase in the average price level of a basket of selected goods and services in an economy over time can be used to calculate a quantitative estimate of the rate at which buying power declines. A rise in prices, commonly stated as a percentage, indicates that a unit of currency now buys less than it did previously. Inflation is distinguished from deflation, which happens when money's purchasing power rises while prices fall. Inflation that is continually too high can harm households' well-being, especially if it is not offset by comparable salary increases, resulting in lower purchasing power. However, chronically low inflation limits the ability of monetary policy to boost the economy and may indicate that the economy is operating below capacity, limiting the potential for more job creation (investopedia.com, 2022).

Inflation in the Construction Industry

Many industrialized economies are experiencing rapid increases in inflation rates, and the impacts are being felt by the construction industry. In addition to the fact that trained personnel and necessary materials are now much more expensive, supply chain pressures and shortages are making it more difficult to obtain building materials (Outram, 2022). The cost of several commodities, like steel and lumber, which are essential for construction projects, has skyrocketed. Although the COVID-19 pandemic-related supply chain interruptions were the foundation of the issue, other difficulties, such as geopolitical threats, continue to exert pressure on pricing. The demand for construction materials is also rising as a result of an increase in government-led infrastructure projects (Outram, 2022). Jason Kinsale, Aristo Development's principal, told Tribune Business that he predicted that his 11-story Aqualina development will likely implement “three more price increases of 5 percent” before construction is completed by December 2023 (Hartnell, 2022).

Literature Review

Any country's prosperity can be determined by how well its building industry performs in providing infrastructure. The construction sector is big, unstable, and expensive to invest in. Cost and schedule overruns have always plagued big building projects (Flyvbjerg et al. 2002). Numerous factors, including cost escalation, typically originate from market forces, reflect rising labor and material costs, and increase levels of construction activity. (Hanna and Blair, 1993). Cost escalation is a risk that exists particularly in long-term projects where variability and uncertainty are greater and can contribute significantly to construction costs. Cost escalation's effects on multi-project initiatives are of great concern. As a result, it's important to evaluate the possibility of cost growth in construction plans. Using cost escalation clauses in the contract is one way to reduce the impact of cost escalation during periods of high inflation. Cost escalation clauses are required to prevent the contractor from incurring significant cost overruns and to lessen the amount of risk included in the contractor's bid.

Project participants have little choice but to postpone the project to avoid cost overruns, due to inflation (H. Alinaitwe, R. Apolot, D. Tindiwensi, 2013). Building materials affect the overall cost of building by 35% to 60% (Edward Arnold, 1981). The time lag behavior of these components is the underlying theory underlying how inflation impacts the cost of building materials, labor costs, and equipment rental rates (C.F. Tang, 2014). The cost of materials can also be seen to rise as the rate of inflation does. Due to the ambiguity of inflation, both clients and construction companies must not only take into account the possible increase in building expenses but also assume additional fees (R.K. Shah, 2016).

Both industrialized and developing nations experience cost overruns in the construction sector. Cost variation can be positive or negative in construction projects, and if it's positive, it means the project's costs will exceed expectations (Transp Policy, 2019). Cost overruns and inflation in public and private building projects are significantly correlated (AWAM International Conference on Civil Engineering, 2019). According to Oghenekevwe et al., the primary source of cost overrun anxiety is the increase in inflation-related costs for construction supplies. Goyal (2017) concluded in his analysis that inflation is to blame for the increase in material prices, which results in cost overruns. Additionally, he stated that inflation affects both labor wages and material prices, which influences the whole project cost.

Factors Affecting the Construction Industry

Supply and demand, market circumstances, transportation and energy costs, raw materials, labor costs, crude oil prices, exchange rates, import tariffs, and inflation are some of the primary elements that affect construction costs as well as the output of the construction sector. Global economic recovery is greatly aided by the construction and engineering industries, which create millions of jobs. Furthermore, it increases revenue as a result of international trade in engineering services and building materials (Karachi, Pakistan; 2008). In July 2019, the world's construction sector had 7,505,000 employees. By 2026, it was expected to add 864,700 new employees, with an average growth rate of 12 percent (Doyle, 2019).

Any building project's primary criterion is its budget. It is typical for the budget to be altered in projects with a protracted timeline. The cost of labor, building materials, and machinery all rise annually as a result of inflation, which is one of the causes of this. The cost of labor, materials, and equipment rises as a result of inflation, which affects both the project's original and final costs (R. Islam, A.B.A. Ghani, E. Mahyudin, N. Manickam, 2017). Economic growth is unstable because construction expenses are unstable and materials and other costs are constantly changing in price. Although labor and material prices are impacted by inflation, contractor and supplier margins have a significant impact as well. Inflation in the construction business varies throughout markets and across different industries and on the types of materials used (Edzarenski.com, 2019). Given the significant investments required, the construction industry is crucial for any country looking to develop its economy.

Inflation affects labor earnings in addition to raising the cost of materials (M. Siemiatycki, 2009). In a study on the rising cost of building supplies in the Nigerian state of Lagos, Akanni et al. conducted a quantitative analysis of the factors influencing the price of building supplies. According to the report, there was an upward trend in construction material prices from 2003 to 2012, with annual inflation rates ranging from 5% to 21% (SAGE Open, 2014). Tang investigated the impact of inflation and actual labor wages on Malaysian productivity. Real labor earnings, inflation, and productivity were found to be related in Malaysia between the years 1970 and 2007, according to the study's findings. The investigation also showed how negatively inflation affects productivity, proving the importance of real labor salaries and inflation for productivity in Malaysia (C.F. Tang, 2014). Additionally, if labor expenses continue to rise, they will soon become more difficult for new workers, which is a significant obstacle because it prevents the sector from growing (T.I. Times, 2019).

Methodology

The time horizon of this paper is cross-sectional, meaning that all data was collected and reviewed at one point in time. Data was primarily accumulated by reading several news articles, scholarly articles, and interviews. Additional data was sourced from statistics and analytics. This data will be analyzed for its content, meaning information will be taken at face value, and similar sources will be compared to determine consistency in information.

Discussion

The average annual inflation rate in The Bahamas from 1967 to 2020, the monitoring period, was 4.1 percent (Worlddata.info, 2021). This rate was compared to the United States from 1980 to the current day, with projections into 2027. This is depicted in Figure 1, which depicts the historical trend of inflation during this time between both the United States and The Bahamas.

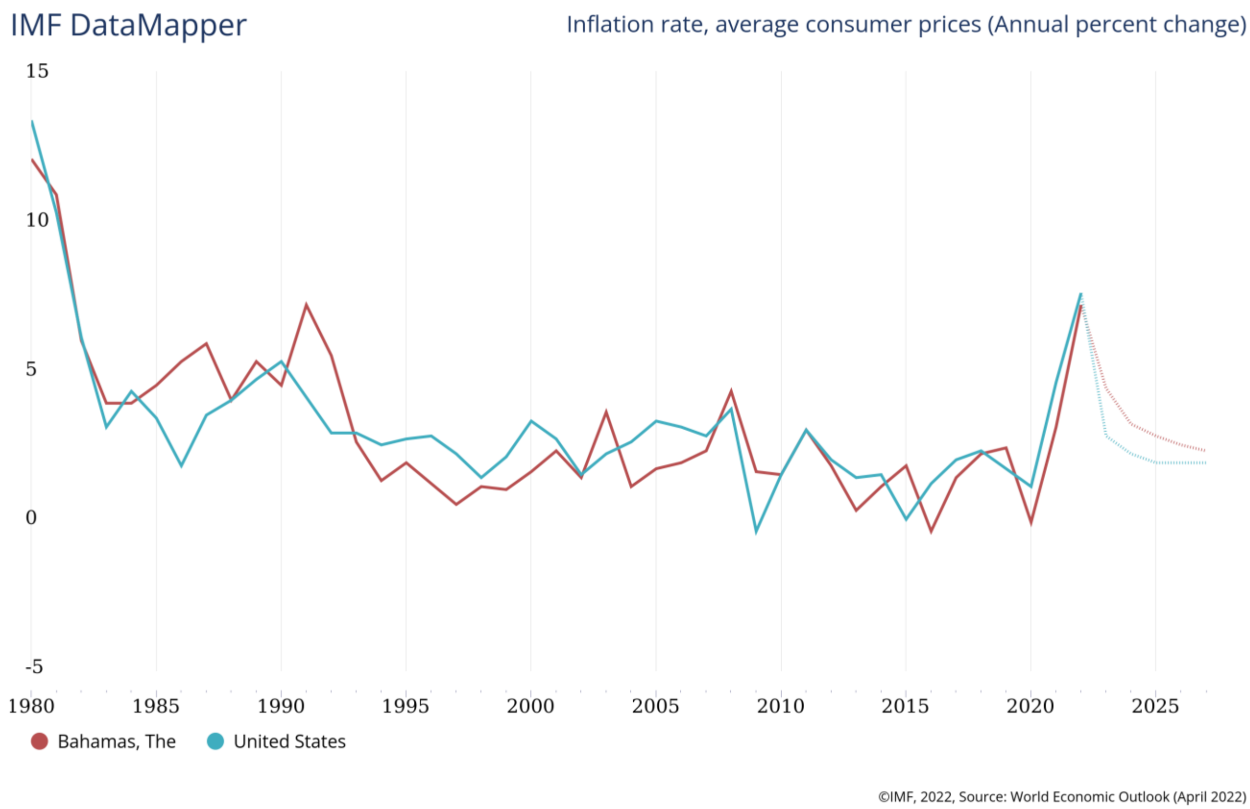


Figure 1: Inflation Rate (Average Consumer Prices, %)

Source: Imf.org

Inflation and the success of the construction sector are related, and this influences economic expansion. The construction industry is suffering the effects of rising prices, from ballooning prices of steel, lumber, and fuel (see Figures 2, 3, and 4). In Figure 2 we see that in the United States over the last 18 months prices have skyrocketed to a markup of 219%, and lumber peaked in June 2021 at 300% but fell in the subsequent month to less than 15%.

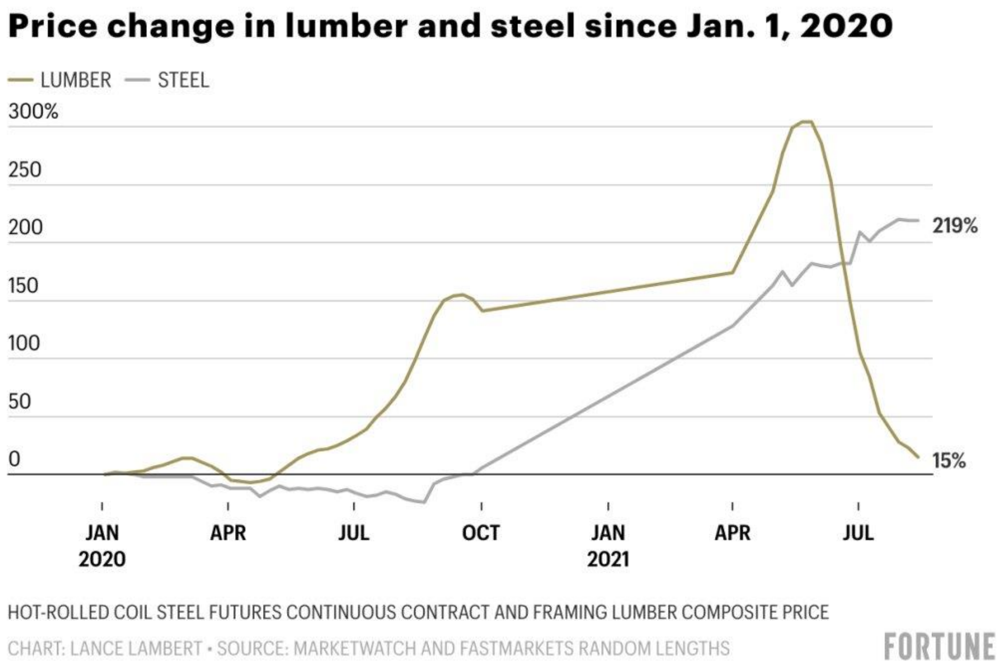


Figure 2: Price Change in Lumber and Steel Since January 1, 2021.

Source: Fortune.com

In Figures 3 and 4, it is observed that US crude stockpiles surged by 4.76 million barrels during June of 2022, according to the American Petroleum Institute, while gasoline and distillate supplies rose by 3 million and 3.3 million barrels, respectively. Meanwhile, OPEC predicted that the oil demand will increase globally in 2023.

Figure 3: Crude Oil Price Change

Source: Tradingeconomics.com

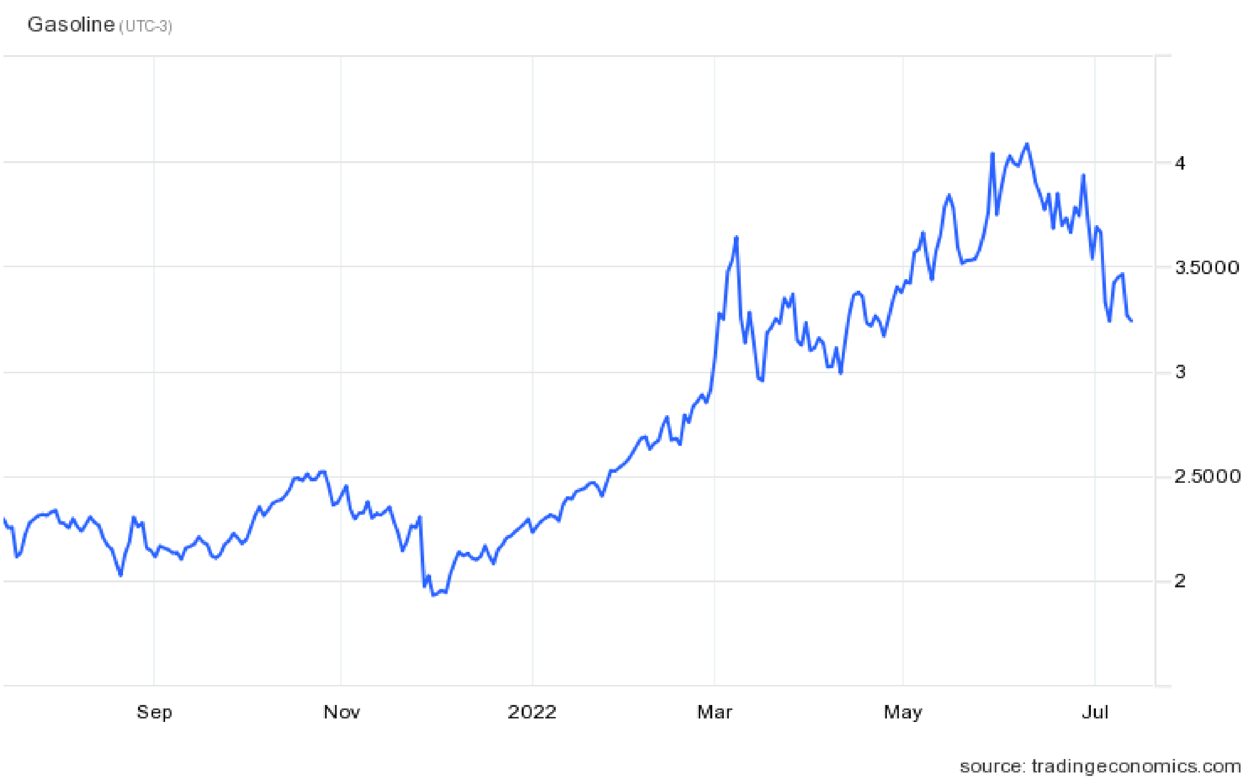


Figure 4: Gasoline Price Changes

Source: Tradingeconomics.com

Earlier this year Richard Gurney, Global Head of Construction within Marsh Specialty said, “We have an environment where contributing factors are and will be impacting the construction industry, such as increasing demand for infrastructure as a stimulus to COVID-impacted economies, increased construction activity driven by measures to alleviate the impacts of climate change, and a shrinking and changing labor market driven by pandemic-related retirement and local restrictions.”

In a December 2021 interview with The Tribune, President of the Bahamian Contractors Association (BCA), Mr. Leonard Sands said fixed-price contracts that don't account for 40% cost increases had put several contractors "on the brink of collapse" (McKenzie, ewnews.com, 2021). "If the market goes up and down, it's always the contractor that takes the hit. With construction financed through the private sector or the client, some adjustments can be made to the inflation rate of the day, but not with fixed or bank contracts", says Sands (McKenzie, ewnews.com, 2021). This assertion can be supported by evidence since one issue is related to defects and changes in the market price of the construction-related inputs (Paulos, 2002). The construction industry's expansion is also significantly hampered by the deficiency and market price volatility of construction inputs (Paulos, 2002).

Sharp price rises force contractors to abandon their projects before they can be finished within the client's acceptable time and quality margins and within the budgeted cost margins (Paulos, 2002). Contractors are primarily engaged in a variety of operations that are directly impacted by the state of the market. Every construction contract requires the contractor to provide a rate quote based on the design, specifications, available bill of quantities, and market rates for laborers and building supplies at the time the bid is prepared and submitted.

While carrying out the activity specified in the contract, the cost of the construction work will change depending on whether labor costs are higher or lower than anticipated. The contractor will request a higher rate if the cost of the construction work grows, and the owner will request a lower rate from the contractor if the cost of the construction work decreases (Paulos, 2002).

One of the main causes of material price fluctuations in the construction industry is imported inflation (Riggs, 2006). Imported inflation is defined as the prices of imported components, materials, and fuels rising, increasing the cost of production at home and pushing up the cost of things made there (Oxfordreference.com, 2022). Most of the machinery, building supplies, and furniture used in resort hotels in The Bahamas are imported from the US (Trade.gov, 2021). In a March 2022 press release (Bahamas Information Services, bahamas.gov.bs, 2022), Prime Minister Davis, concerning imports from the United States said, “at the moment, it is not easy to determine the extent of that impact, but anything that affects any of our major trading partners, such as the United States, will almost certainly impact us.” The Minister of Economic Affairs, Michael Halkitis, has stated that the inflation is mostly due to importation.

Tourism-related foreign direct investment (FDI) boosted the construction industry (repositorio.cepal.org, 2020). The construction of new hotels and second homes using hurricane-resistant materials, as well as the development of ports and the sale of goods and services to the marine and yachting industries, are all promising subsectors (Trade.gov, 2021).

In a recent interview with Eyewitness News, President Leonard Sands stated that the local construction industry would see a "boom" during the upcoming 24 months and that customers are very near to "awakening" to the rising cost of construction (ewnews.com, 2022). This claim can be paired with the prediction that over this same timeframe, inflation is expected to decrease. The projected decline in global growth from 5.7 percent in 2021 to 2.9 percent in 2022 is a sharp decline from the January projection of 4.1 percent. Over 2023–2024, it is anticipated to maintain that pace (Worldbank.org, 2022).

How to Combat Inflation

So far, the paper has focused specifically on the construction sector however, inflationary pressure will be felt over all sectors. As such, it needs to be determined how

The Bahamas can protect the country from being negatively impacted specifically by the emerging trends of fuel price increases. So, what options can be explored to help combat inflation? There can be an adjustment to the taxation infrastructure, implementation of living wages, inflation targeting through monetary policy, and price controls.

Taxation and Inflation

Public finances have gotten worse and medium-term growth issues have gotten worse as a result of the pandemic. School-aged children had substantial learning setbacks, and it will take time for employees to return to the workforce as many institutions downsized. The pandemic may also have long-term consequences for travel, technological changes, and climate issues. The incoming administration has promised to aid by cutting taxes and raising spending on investments and education. However, there is little room for maneuvering because of the high financing costs and a public debt that is almost equal to GDP (Quarterly Statistical Digest 2021 [November], 2021).

As it pertains to government policies, The Bahamas introduced Value Added Tax (VAT) in January 2015 at a rate of 7.5%, with specified exemptions. This rate was later raised to 12% in July 2018. On January 1st, 2022, following a change in administration, this rate was decreased to 10%, but now includes breadbasket items, which were previously exempted. A lot of citizens seemingly attributed this change as a cause for increased inflation. The Bahamas Government said that VAT will be imposed to counteract the future decreases in import duty rates that will accompany the territory's membership in the World Trade Organization, as well as to begin consolidating the territory's finances (Ministry of Finance, 2017).

In a January 2022 interview with The Tribune, the head of the Abaco Chamber of Commerce, Ken Hutton stated that there are many irate people in Abaco, calling it "unconscionable" because the government has not yet reversed the VAT return on building services (Hartnell, 2022). In response, the government advised that household equipment, furnishings, appliances, hardware supplies, building supplies, electrical fixtures and materials, and plumbing fixtures and materials are now exempt from VAT and duty until December 1, 2022 (Ministry of Finance, 2022). The *White Paper on Tax Reform to Secure Adequate Revenues for the Future* (bahamas.gov.bs, 2013) mentions income, payroll, and consumption tax (which eventually became VAT).

Implementation of a Living Wage

The amount of income a person makes also impacts the level of consumption and whether they can sustain large increases in inflation. Adjusting to living wages can assist in combating

inflationary pressure. A living wage is the least amount of money required for a worker to meet their fundamental necessities. According to Julia Kagan, the minimum wage should be raised to reflect a livable wage. She notes that because the minimum wage does not increase with inflation and can only be increased by congressional action, it does not offer a sufficient income to support oneself (Kagan, 2022). When you make a living wage, you can afford to pay for things like housing, food, healthcare, daycare, taxes, and transportation. A livable salary might also vary depending on your situation, including your area of residence (Kagan, 2022).

A lot of countries within the UK have implemented a living wage. There has been an active living wage campaign in the Republic of Ireland since 2014 (Livingwage.ie). Specifically, Ireland's current living wage is €12.17, roughly €2 more than the current minimum wage of €10.50. With the hope of starting as soon as January 2023, the much-appreciated raise will result in the lowest legal salary in Ireland being €12.17 per hour (Collins, 2022). This hourly rate of pay has always been significantly higher than the listed minimum wage (Budgeting.ie).

The advantages of a living wage are shared between employers, employees, and the community at large. Ireland implements a living wage, some of the advantages that can be experienced are higher employee loyalty, better productivity, reduction in the expense of recruiting, training, and replacing missing employees, and sufficient income for citizens to take care of living expenses without financial strain, and increased consumer buying power, which can lead to the growth of the local economy (Wechu.org, 2021).

Unfortunately, living wages are very controversial and may be difficult to implement in The Bahamas. This is due to their disadvantages, inclusive of the idea that implementing a living wage creates a wage floor, which hurts businesses, particularly small ones that can't afford to raise wages, damaging the economy (Kagan, 2022).

Inflation Targeting

Today, a more favored technique of reducing inflation is contractionary monetary policy. The Central Bank of The Bahamas says that the fundamental objective of monetary policy in The Bahamas has always been to reduce the economy's money supply by raising interest rates and other conditions to support the fixed parity between the Bahamian and U.S. dollars, allowing the economic development objective to be pursued (centralbankbahamas.com). Interest rates rise when the money supply is reduced, whereas they fall when the supply is increased. The key metric for monetary policy used by many modern central banks is the rate of inflation in a given nation (Ross, 2021). Central banks tighten monetary policy by raising interest rates or adopting other hawkish measures if prices increase faster than their aim. Higher interest rates make borrowing more expensive, which reduces both investment and consumption, two activities that significantly rely on credit. Like this, the central bank will reduce interest rates and make borrowing less expensive along with several other potential expansionary policy tools if inflation falls and economic production declines (Ross, 2021).

A central bank method known as inflation targeting involves setting an inflation rate as a target and modifying the monetary policy to attain that rate. Although its proponents believe it will also promote economic stability and growth, inflation targeting primarily focuses on maintaining price stability (Jahan, 2022). The central bank projects where inflation will go in the future and compares that to the desired inflation rate (the rate the government believes is appropriate for the economy). The amount that the monetary policy must be modified depends on the discrepancy between the prediction and the target. While other nations have specified simply a target rate or an upper limit to inflation, some have chosen inflation targets with symmetrical ranges around a midpoint. The majority of nations have placed their inflation goals at low single-digit levels. The fact that inflation targeting incorporates aspects of both monetary policy rules and discretion is a significant benefit.

Inflation targeting has been widely adopted by central banks from various regions and from advanced, emerging markets, and developing economies (see Figure 5). Full-fledged inflation “targeters” are nations that explicitly commit to meeting a given inflation rate or range within a given period, routinely disclose their targets to the public, and have institutional procedures to guarantee that the central bank is responsible for achieving the target (Jahan, 2022).

Figure 5: Inflation Targeting by Country

TARGETING INFLATION

Countries across the world have adopted inflation targeting irrespective of their income level.

COUNTRY	INFLATION TARGETING ADOPTION DATE	TARGET INFLATION RATE AT TIME OF ADOPTION	COUNTRY	INFLATION TARGETING ADOPTION DATE	TARGET INFLATION RATE AT TIME OF ADOPTION
New Zealand	1990	1 – 3	Philippines	2002	4 +/– 1
Canada	1991	2 +/– 1	Guatemala	2005	5 +/– 1
United Kingdom	1992	2 (point target)	Indonesia	2005	5 +/– 1
Australia	1993	2 – 3	Romania	2005	3 +/– 1
Sweden	1993	2 (point target)	Serbia, Republic of	2006	4 – 8
Czech Republic	1997	3 +/– 1	Turkey	2006	5.5 +/–2
Israel	1997	2 +/– 1	Armenia	2006	4.5 +/–1.5
Poland	1998	2.5 +/– 1	Ghana	2007	8.5 +/–2
Brazil	1999	4.5 +/– 2	Uruguay[1]	2007	3–7
Chile	1999	3 +/– 1	Albania	2009	3 +/– 1
Colombia	1999	2 – 4	Georgia	2009	3
South Africa	2000	3 – 6	Paraguay	2011	4.5
Thailand	2000	0.5 – 3	Uganda	2011	5
Hungary	2001	3 +/– 1	Dominican Republic	2012	3–5
Mexico	2001	3 +/– 1	Japan	2013	2
Iceland	2001	2.5 +/– 1.5	Moldova	2013	3.5–6.5
Korea, Republic of	2001	3 +/– 1	India	2015	2–6
Norway	2001	2.5 +/– 1	Kazakhstan	2015	4
Peru	2002	2 +/– 1	Russia	2015	4

Sources: Hammond 2011; Roger 2010; and IMF staff calculations.
Note: Countries are classified as inflation targeters based on the IMF’s Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) database.
[1]Adoption date is based on the starting point when the interest rate became the main monetary policy instrument.

Source: Hammond 2011: Roger 2010 and IMF staff Calculations

If The Bahamas implemented inflation targeting, it would be able to respond to domestic economic shocks and prioritize domestic concerns. Some additional potential benefits are reduced inflation volatility, reduced the inflationary impact of shocks, and increased anchoring of

inflation expectations (frbsf.org, 2013). As it pertains to the aspect of inflation that should be targeted, core inflation (excluding food, energy, and other volatile components from the headline.

CPI) has been viewed as the most appropriate measure of inflation since fluctuations in food and energy prices represent supply shocks and are non-monetary (Wynne, 1999).

Price Controls and Inflation

A third method that can be explored in an attempt to combat inflation is price controls. Investopedia.com defines price controls as “the legal minimum or maximum prices set for specified goods”, which are usually mandated by the government (investopedia.com). In 1971, when the US was facing increasing inflation, President Richard Nixon implemented several measures to stop the bleeding, so to speak (cato.org, 2011). One of these measures was price controls.

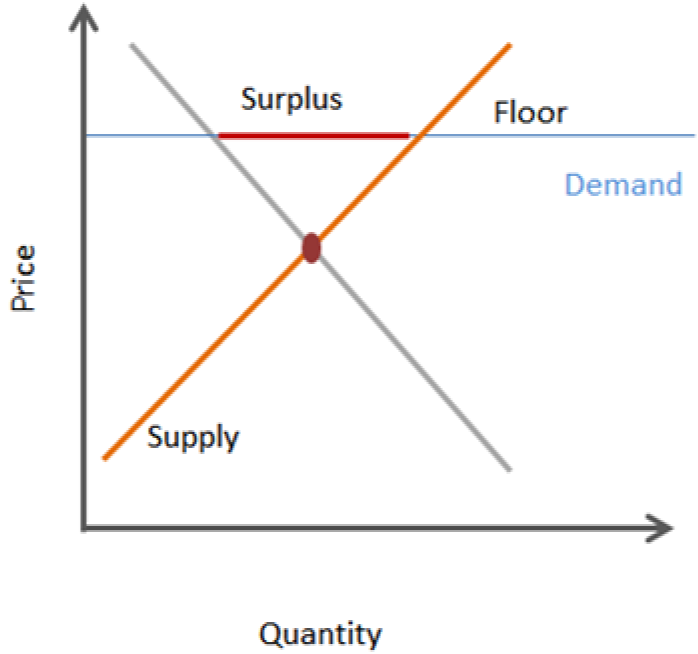
This method may prove to be the least effective of the three mentioned in this paper, but if used correctly can still have a positive impact. As The Bahamas already has price controls in place, it would be best to only set this mandate for a specific period (maybe over 2-5 years). This is because price controls work best when there are high demand and supply chain shortages (Pettinger, 2022). Additionally, these mandates can be reserved for essential items, such as food or rent.

Demand-pull inflation happens when overall demand grows at an unsustainable rate, putting more pressure on scarce resources and creating a positive output gap. Cost-push inflation is when businesses raise prices in response to growing costs to maintain their profitability. While government changes to the cost of utilities and levies are linked to administered pricing. Several additional variables, including the total money supply, exchange rates, gross domestic product (GDP), and foreign exchange reserves, also have an impact on the inflation rate (Jurnal Ekonomi & Studi Pembangunan, 2013). Prices have increased as a result of inflationary pressures brought on by the economy’s supply and demand sides (Investopedia.com, 2016).

However, price limits will reduce the incentive for businesses to manufacture goods, which would reduce employment. According to research by Paul Evans, price restrictions during World War II were successful in keeping prices 30% lower than they would have been otherwise, but at the cost of a 12% decline in employment and a 7% decline in productivity (Pettinger, 2022). Furthermore, controlling prices doesn’t address the root cause of inflation. For instance, if excessive demand is what drives inflation, price limits will just increase the allure of the commodities while keeping demand constant (Pettinger, 2022). If a lack of available commodities and cost-push factors are the root causes of inflation, lowering price caps won’t help to alleviate the scarcity.

Figure 6 demonstrates how price caps cause shortages. The red circle indicates the market price, while the blue ceiling line is below this, indicating a shortage. Controls first appear to be beneficial ways to assist customers (or suppliers, depending on the control); nevertheless, regulating the price of a good interferes with basic economic principles. There are repercussions from this deception, particularly when it comes to global trade.

Figure 6: Price Caps on the Demand and Supply Curve



Source: Econlib.org

Conclusion

When focusing on the construction industry, the impact of inflation is evident. The increase in inflation rates reduces GDP while increasing construction expenses. The GDP affects the inflation rate of countries, and vice versa occasionally. Although the increase in inflation reduces GDP, it rises construction expenses. Construction expenses are influenced by a variety of elements, but mostly by building material costs, labor costs, machinery hire rates, and consultancy costs, all of which are directly impacted by inflation rates and lead to project cost overruns. With this in mind, some actions that can be taken to reduce the impact of inflation are to implement inflation targeting, explore using a living wage, create price controls, and adjust taxes. The strongest of the four options is inflation targeting, which enables central banks to react to domestic economic shocks and concentrate on home issues.

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