FOREIGN INVESTMENT AND EXCHANGE CONTROLS

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Bahamas Chamber of Commerce and Employers' Confederation
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Introduction

Good Morning ladies and gentlemen, I would like to thank the Bahamas Chamber of Commerce and Employers' Confederation for once again inviting me to speak at the "State of the Economy Report" Conference. I commend the Chamber for this initiative, which allows not just for presentations on important economic topics, but also feedback from the business community on issues, which are of vital importance to the country. My topic for today is "Foreign Investment and Exchange Controls", which is timely, given the rollout of the latest Exchange Control liberalisation measures on February 1st of 2018[1].

The Usefulness of Exchange Controls

Notwithstanding the present debate on the usefulness of the exchange control regime, it is important to note that the controls do ensure that adequate foreign exchange flows are always available to support the fixed parity of the Bahamian dollar against the US dollar (B$1.00 = US$1.00), for all trade payments and approved investment outflows. At the inception of the peg, The Bahamas introduced an essential convenience for the tourism sector, removing the nuisance of exchange rate conversions from over-the-counter transactions, and unifying the pricing of goods and services offered to both tourists and residents. Being pegged in this fashion remains aligned with having the majority of our tourists (over 80%) originate from the United States, as well as this being the principal trading partner for imports.

[**] ***As prepared for delivery.***

[1] The liberalization of exchange controls entails the relaxation of controls set in place to monitor foreign exchange transactions within an economy, thereby allowing more flows of capital of both an investment and trade nature to come in and out of the country. The economic spillover effects can be both positive and negative, depending on its impact on the value of the currency, and the policy tools used by a country.

Today it would be easier to jettison the "convenience" arguments around having the exchange rate fixed, because technology and reliance on electronic payments make it easier to convert between multiple exchanges at the typical point of sale. It is less persuasive, however, to distance ourselves from the other benefits of having a stable exchange rate, or to mount strong arguments as to why a floating exchange rate would somehow eliminate international competitive disadvantages that currently exist in the Bahamian economy.

Exchange rate stability provides more certainty and predictability for Bahamian inflation, which is closely linked to that of the US. Since the 1990s, the US' average annual inflation has been relatively stable in the 2.5% range, with The Bahamas not much different. Low and relatively predictable inflation, as has been experienced in The Bahamas, makes it easier for businesses to negotiate wages with trade unions—which is good for the labour markets. It is also favourable for investors, who are spared uncertainly over the value of their investments and profits, which eventually have to be repatriated. Uncertainty can also discourage long-term investments[2].

The common assumption in economics is that a depreciating currency could make it easier for a country to boost exports and grow its economy. By this reasoning, it might be tempting to imagine that The Bahamas could embrace devaluation to make tourism and other exports cheaper and therefore increase its foreign exchange earnings potential. However, the economy is structured differently and, even over the long-term, is unlikely to experience the level of structural transformation to make such a line of reasoning valid. As an example, the inputs to tourism are largely imported, and would require the same amount of foreign exchange to be sustained after a devaluation. In addition, workers base their wage demands on the cost of living, which is driven by the expense of imported goods and services—the so-called "cost push" inflation phenomenon. As these cannot be supplied locally either sensibly or feasibly at lower cost, they would still have to be imported. Taken together, if the Bahamian dollar were to be allowed to devalue or depreciate, prices for exports would stay close to same in US dollars, but prices would be inflated in local currency, to offset the rate of depreciation.

This does not dispose of the competitiveness issues or the fact that there are current macro-economic imbalances in The Bahamas. Any necessary improvement in competitiveness requires that our jurisdiction tackles the multitude of other factors that add to the cost of "doing business" or which reduce the perceived quality of the products that are exported. The Chamber's membership is well versed in these issues, which therefore need not be recited today. The membership is also well versed in the macro-imbalances of a fiscal nature and how these ought to be confronted.

It takes us back, therefore, to striving to maintain a stable exchange rate environment, and having the right tools to do so. Preserving the exchange rate regime is only incompatible with liberalisation, if liberalisation proceeds faster than the pace at which we can maintain a state of

[2] See: Seven L., "Real Exchange Rate Uncertainty and Private Investment in LDCs". The Review of Economics and Statistics, February 2003, 85(1): 212–218.

confidence and calm, or if policy makers relinquish control over activities that on a net basis, result in foreign exchange shortages within the economy. These are ongoing points of deliberation for the Central Bank.

To set the context for The Bahamas, our terminology needs to evolve, so that we discuss controls as they apply to capital and financial flows. This is where the impact of current policies is most binding and where, in the short-term, improperly managed flows would have the swiftest consequences for the exchange rate.

For any economy, capital and financial flows should be manageable and sustainable. On some level therefore, active public sector policies are required to achieve this—and most often, it would be through taxation which involves the Ministry of Finance or its equivalent, or through the interest rate and prudential policies of the Central Bank. Relinquishing the hands on approach that is now taken in The Bahamas, would require that such alternative, effective policy management tools pre-exist. This is in addition to matters of confidence which touch on how well the public sector's finances are transitioned to a sustainable long-term trajectory, and how financial sector vulnerabilities are kept in check.

International Flows & Foreign Investments

Most of the emphasis on foreign investments relate to the long-term financial flows that our economy attracts. These are flows that are expected to boost the economy's growth potential and the national standard of living, especially in so far as improving the foreign exchange earnings sectors potential.[3] The investments in the foreign exchange sector provide the basis for the "organic" growth needed in external reserves over the medium and longer-term. In turn, growth in the reserves would, along with confidence building policies, provide the buffer for more liberal policies on capital flows.

As the IMF has noted, foreign direct investment may raise concerns about foreign ownership and control; however, there is considerable evidence that economic benefits, such as technology transfer and efficient business practices, can accrue to the receiving country.[4] What is important therefore is that our country exploits the means to extract more knowledge transfers from direct capital inflows, so that the participation in the respective sectors can be successfully replicated for local ownership. Indeed, looking at the financial sector there are prominent examples of Bahamian owned entities that compete at international levels. The challenge would be to replicate this more, even when local controlling interests are allowed to raise capital outside The Bahamas.

[3] This is not to undervalue the importance of social factors that feed into the quality of life, such as health and personal safety.

[4] See: "Capital Account Liberalisation and The IMF". Finance and Development, Dec. 1998, Vol. 35, No. 4.

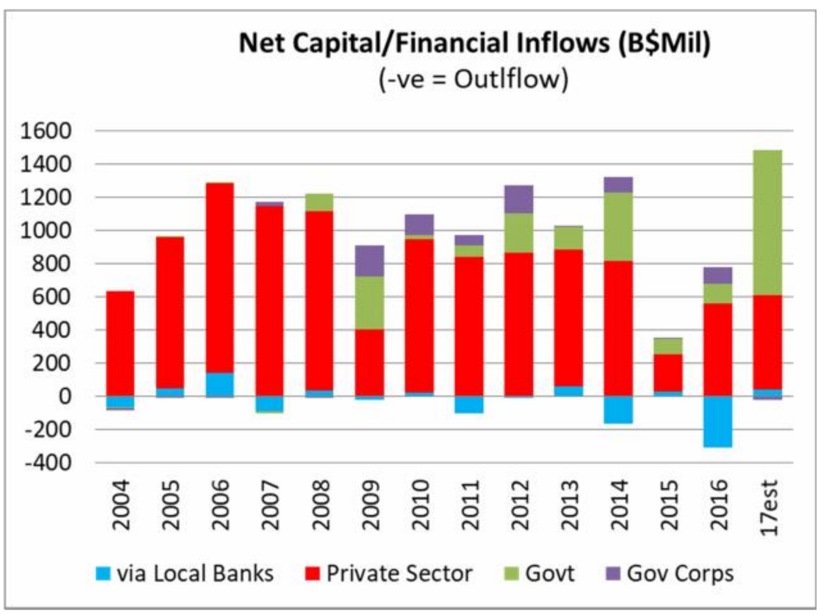
The users of international flows include the government, public sector and the private sectors. The inflows take at least three common forms:

- Net external funding through commercial banks that is on-lent mostly to the public sector and larger borrowers in the tourism sector.[5]

- Direct debt financing for the sectors just named and for other private sector actors. For the private sector, borrowing for real estate purchases is also a common use of such resources. In the public sector, both infrastructure and general expenses attract debt funding.[6]

- Direct equity financing for the private sector, again dominated by tourism and real estate transactions.

The effect of the recent round of exchange control liberalisation measures, is that the private sector recipients of capital inflows, will now also include an increasing concentration of Bahamian owed firms. In the past, the recipients or controller of these inflows have been predominantly non-Bahamian owed businesses.



Source: Central Bank of The Bahamas

[5] The net financing resources for commercial banks show up in their net foreign liabilities position. It is the approximate amount by which lending in foreign currency in the local economy exceeds foreign currency deposits held by residents.

[6] Multilateral funding is most often linked to specific projects; bank financing is more often project related for public enterprises than for the central government.

During 2016 and 2017, The Bahamas experienced an upturn in long-term capital inflows, underpinned by rising interest in the private sector, but with performance still subpar to the 2006-2008 period, and lower than during the immediate years before 2015. Total net inflows in 2017 are projected to have just exceeded $1.4 billion (approximately 60% attracted by the public sector) from a reduction to near $360 million in 2015. As to direct investment flows to the private sector, average net receipts exceeded $850 million per annum during 2010-2014, at the peak recovery of construction on tourism projects. This was still reduced from average inflows just above $1.1 billion per annum during 2006-2008. In 2017, net direct receipts to the private sector are estimated to have reached almost $600 million, after softening to less than half this amount in 2015.

A prime example of the impact of foreign investment in The Bahamas has been, and continues to be the development of tourism projects, with first round benefits for construction and a medium to longer-term boost to industry output and employment. While Baha Mar has been the most visible of such recent projects, there are other significant developments in New Providence and the Family Islands (resorts and onshore cruise facilities) representing proposed investments of an estimated $380 million[7], and which are at different stages of development and in their contribution to growth. New progress has also been signalled for Grand Bahama in the energy sector, and for both potential expansion and restoration of tourism facilities.[8]

Increasing the Investments Volumes

The challenge for The Bahamas, with both foreign and domestic capital, is to boost the annual rate of private sector investments as a share of GDP, in combination with generating stronger returns from these activities. Otherwise, as has been estimated by the IMF, The Bahamas' medium-term growth potential could remain below 2 percent per annum, once the transitional impact of current activities has been felt. This keeps the focus on total investments both foreign and local in the domestic economy.

Stimulating more locally sponsored investments, requires the conversion of a higher share of domestic financial resources into long-term investments. A first option would be to have these resources invested internally. In this case, the recent exchange control liberalisation measures can help stimulate such outcomes by allowing local investors to leverage their savings or equity, with resources that they can attract from abroad.

Achieving a higher rate of conversion of local savings into investments can also be realised by investing them abroad. To do this without creating new demand pressures for foreign exchange, would require some redirecting of a greater share of the more than $5 billion in annual payments by the banking system, towards imports of investment goods and services,

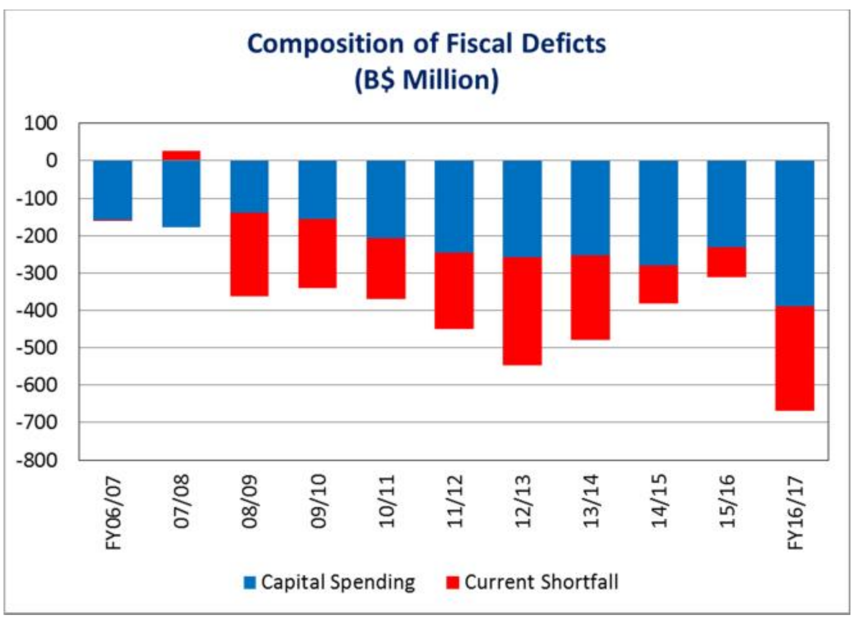
[7] Source: Bahamas Investment Authority.

[8] Government has signed a Heads of Agreement with Oban Energies, to construct a $4.0 billion project on Grand Bahama, which encompasses an oil refinery and a 20 million barrel liquid storage facility, along with the creation of approximately 600 jobs, once it's completed.

rather than for consumption of goods and services. If desired, more of these same resources can also be redirected to pay for portfolio and direct investments abroad that also generate income for the economy. What has not materialised yet however, are the private sector mechanisms that would achieve these outcomes. This would mean bypassing some of dependence on commercial bank credit and harnessing more liquidity already within the system for productive investments.

The high levels of liquidity within our financial system underscore first, that there are significant idle levels of domestic resources that can be put to use, even in the context of the Central Bank's conservative monetary policies, that would only have these drawn-down in a gradual fashion. Also evident in the data, is the fact that the business sector now controls more of the excess liquidity than they did at the middle of the last decade. In fact, about 30% of the total Bahamian dollar deposits are currently controlled by businesses, compared to 25% about a decade ago.

Even investments that are channelled through the Government, can have a sustained positive impact on the foreign reserves. This is different from the initial impact when the debt is taken, and relates to the stimulus that public infrastructural and other works provide for the private sector: such as the improved road network in New Providence, the Airport modernisation, and objectives of the water works projects over the years.



Source: Central Bank of The Bahamas

However, not all of the external financing channelled through the public sector ends up as investments. In the last decade, with just a single exception, fiscal deficits have included revenue shortfalls in paying for current expenses. A successful fiscal reform programme would close this gap, and strengthen the link between public debt and public sector investments.

Indeed, successful reforms would generate savings that also finance some of the public sector's investments.

Increasing Investment Yields

Higher volumes of investments do not always translate into higher growth. The data for The Bahamas shows that returns from investments are subpar compared to the progress in some other countries—this is the total factor productivity "puzzle". Using standard frameworks to explain growth, the measurable inputs considered would include capital, labour and other tangible resources. To these are added unseen estimates for factors such as "know how" or inherent productivity or "cultural" qualities. When one tries to explain annual growth rates in The Bahamas in such frameworks, the unseen factors show up as being negative—subtracting from, rather than adding to potential growth.[9] Put another way, the same amount of capital invested in The Bahamas has been generating less growth than if were to be deployed in some other countries. Put yet, another way, The Bahamas already has to attract a greater volume of foreign investments than some other countries would be required to, just to maintain its current growth rate.

If we were solve this puzzle, we would have done much to address the concerns about the level of potential economic growth over the medium-term. Let me caution, that this speaks to the productivity side of business operations and potentially to the composition of investments that The Bahamas attracts. It has to be tackled with the same vigour as the "doing business" indicators, which are within the direct realm of the Government.

As to the ease of business, reforms to the administrative process for exchange control, are with both the investment and operations side of business in mind. For the most part, the operational needs are being addressed by greater delegation of authority to commercial banks to process foreign currency transactions. For investments, in addition to exploring how to streamline documentation requirements, the Central Bank will fine-tune and expand the use of its electronic portal, that was introduced in 2017. We are also liaising with The Bahamas Investment Authority (BIA), ultimately to introduce a single applications portal for foreign investment processing. This will be coordinated with other process reforms that the Government is considering for the BIA.

Recent Exchange Control Liberalization

Now, I would like to focus on some of the other current developments and considerations around capital controls. As controls are relaxed, the Central Bank always has to satisfy itself

[9] See the IMF's 2016 Article IV Consultation Report on The Bahamas: http://www.imf.org/en/Publications/CR/Issues/2016/12/31/The-Bahamas-2016-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-44074

that the fundamental ways in which the foreign exchange markets operate are not compromised. The recent liberalisation process does not undermine this system:

1. First, as the commercial banks currently supply all of the foreign currency used by the private sector, the shift in the delegation of authority to them for certain types of transactions does not affect the overall pool of foreign exchange available.

2. Second, the system remains guarded against volatile short-term flows. Where there is potential for increased outflows of foreign exchange for various investment activities, they are expected to be met from gradually improving earnings from tourism and other exports.

3. Third measures, such as regularising the overseas accounts of Bahamians, has the potential to attract some resources back to The Bahamas; although not necessarily in windfall quantities.

In terms of small and medium-sized enterprises—which account for the majority of the Chamber's members—it is only over time that the Bank expects to see a gradual stepped-up use of access to foreign currency financing from outside The Bahamas. By design, the policy is also meant to encourage interest in activities, with either broad foreign exchange earning potential, or those that promote national development goals.[10] Businesses are now able to enter more conveniently into either equity arrangements or joint ventures with foreign partners. They can also seek credit from such sources, or from commercial banks and private sector arms of multilateral development agencies, such as the Inter-American Development Bank (IDB) and the World Bank. In addition, entities owned by non-residents are now allowed to obtain financing from international banks licensed to operate from within The Bahamas. The reference number that should be kept in mind is that up to $5 million can be accessed every 5 years though these facilities; although the Bank is open to approving larger financing amounts on a case-by-case basis.[11]

Under the liberalisation measures which became effective on February 1st this year[12]; local businesses can now establish and hold foreign currency accounts at commercial banks without prior Central Bank permission. Also noteworthy, was the more than halving in the premium charged on foreign exchange used to fund capital market transactions through the Investment Currency Market (ICM), from 12.5% to 5.0%[13],. These outflows have been relatively modest

[10] The targeted sectors are: agriculture and fisheries, manufacturing, transport—inclusive of land, sea and air—tourism (including hotels and restaurants), construction and real estate for residential tourism, energy and energy conservation, education, health, telecommunications, ICT and infrastructure.

[11] There is no preset limit on borrowing from the private sector arms of multilateral lenders.

[12] See: http://www.centralbankbahamas.com/exc_press.php?cmd=view&id=16813

[13] When the funds are repatriated to the Bahamas, they can be converted back into Bahaman dollars at a premium of 2.5% compared to 10% previously.

over the past decade (approximately $50.0 million) but they are expected to increase given the reduced financing cost. Such investments however, also have the potential to generate returns that can be repatriated to The Bahamas.

The Path to Further Liberalisation

As I have hinted at the outset, The Bahamas must synchronise further gradual liberalisation with reforms to strengthen its financial stability frameworks. This includes coordination across the prudential sector, to ensure harmonised, consistent oversight of activities when these matter for macro-economic stability. This macro-prudential regime must also fully incorporate fiscal policies, aimed at reducing imbalances in the economy. Reducing the deficit and having debt indicators improve over time, underscore a key fiscal contribution that is needed. Included in the mix is reducing the amount of Government debt owed the Central Bank, with legal safeguards to limit future recourses. Not all of the accumulated commercial bank liquidity can be sustainably used. Some of it also needs to be gradually withdrawn from the system through Central Bank initiated policies. This would placate concerns that the Central Bank has about how, if permitted, much of these funds could also fuel speculative attacks against the exchange rate.

Conclusion

As I wrap-up, let me reiterate that The Central Bank of The Bahamas is committed to closely monitoring the economy to identify the policies that can be implemented to undergird economic growth and development. We recognize the need to strive to embrace continued liberalisation of the capital account, to the extent that it is able to stimulate higher rates of national savings and investment and provide more diversification opportunities for local investors. Finally, the speed at which we are able to liberalise our exchange control regime will depend on the impact of the current measures in-place on external reserves, and our ability to implement effective policies at a regulatory and Government level to deal with more volatile and less predictable capital flows, to ensure the stability of the fixed exchange rate regime.

Ladies and gentlemen, I thank you very much for your attention.