The Path to Exchange Control Liberalisation:
Completing the Journey in One Piece

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Bahamas Business Outlook 2018

18 January, 2018

Introduction

A special thanks to the Counsellors for inviting me to make this presentation on exchange control liberalisation. I intend to keep the focus narrowed to issues related to capital and investment flows, as these are the areas where policies and administrative practices have the most substantive impact. Rather than argue that The Bahamas should resist liberalisation, I would instead like to convince you that we should make more credible preparations to do so—but in a stable fashion. I would also like to convince you that some of the roadblocks to liberalisation are matters related to our national investment policy regime, which defines the limits of property rights enforcements for those who might otherwise, already be able to circumvent the exchange control regulations. Finally, there is the question of dollarization, and whether this option would allow The Bahamas to speed up the process of liberalisation.

Purpose and Scope of Exchange Controls

The system of exchange controls, and the monetary policy tools available to the Central Bank are to ensure that The Bahamas is able to maintain the fixed exchange rate, with B$1.00 = US1.00. The parity with the US currency provides a necessary convenience for tourism, which is mostly transacted in US dollars and mostly with US clientele. The fixed exchange rate has also provided a stable anchor for domestic inflation, which has closely mirrored the inflation rate in the United States. This is an achievement almost unrivalled in independent countries in Latin America and the Caribbean, or in most developing countries.

It should also not be so quickly discounted given the importance of stable inflation expectations in the medium and long-term decision making processes of the private sector--whether it is about investments, savings or wage negotiations.[1]

Our exchange controls have been effective, not because they are fool proof, but because they provide safeguards around very liquid and mobile financial flows, which if shifted rapidly could destabilise the exchange rate. Given enough time, people do manage to evade controls but the short-term fallout from such movements is not felt. Meanwhile, the national investment policy provides a check on restricted categories of inflows, because it determines the ease of forming legally binding commercial contracts with non-residents. The downside, however, is that protection can reduce the incentives for expedited structural reforms that would have longer-term benefits. More liberal capital flows do expose policies and policy makers to greater market scrutiny and accountability. It is to our advantage to subject ourselves to such discipline, and to push for reforms that positively reinforce good policies.

The exchange rate peg has only survived because the Central Bank, with the help of exchange controls, has consistently been able to assure a supply of foreign currency to the public at the official rate. The system also allows excess inflows from tourism and other export activities to accumulate in the external reserves until they are needed.[2]

In accommodating foreign exchange demand, the system then distinguishes between international transactions that are current in scope, versus those of a capital or financial in nature. Current transactions, most commonly cover goods and services (including travel), interest and profits on investments and remittances such as expatriate workers' income or

[1] The benefits of the fixed exchange rate and the longstanding ability to maintain the currency peg is an achievement on which The Bahamas receives repeated commendation from the IMF, in the Fund's Article IV Consultation Reports on the country. See for example the 2015 Assessment by the IMF's Executive Board: http://www.imf.org/en/Publications/CR/Issues/2016/12/31/The-Bahamas-Staff-Report-for-the-2015-Article-IV-Consultation-43125.

[2] Except where the policies have been relaxed, the law requires that exporters and those permitted to raise funds in foreign currency must sell the proceeds to the Commercial Banks. Beyond the amounts required for immediate use by their customers for external payments, commercial banks must sell the excess to the Central Bank.

transfers. Capital transactions cover both portfolio and direct investment flows, and the contracted liabilities of individuals, financial institutions and businesses.

The use of foreign exchange is permitted freely to pay for current transactions. In this area, there has been significant delegation of authority to commercial banks to approve payments without prior reference to the Central Bank. A forthcoming round of delegation will provide additional flexibility to banks to approve commercial payments, and particularly benefit medium and larger businesses. For individuals, small businesses and most medium-size businesses, there is already virtually no direct contact with exchange controls for these trade related transactions.

There is, however, a more selective approach in dealing with private financial transactions. Policies have always embraced private direct investment inflows in the foreign exchange earning sectors, but paced slower to accommodate outflows by Bahamians. The ability of Bahamians to make outward direct investments that were not assessed an investment currency premium, only started to be embraced as a policy in 2006, and is now accommodated up to a limit of $10 million, per investment, every three years. The approval process considers whether such investments would produce returns that would be repatriated to The Bahamas.[3] In 2017, access by Bahamians to financing in foreign currency for domestic ventures was also strategically relaxed,[4] with a limit of up to $5 million per business firm every 5 years.[5] This is available for businesses operating in sectors generating positive net foreign exchange impact or where expressed national development goals have been articulated.

On portfolio or potentially liquid investments, the approach has been one-sided. Inflows are still not very much embraced. However, since 2006, Bahamians have been able to invest abroad without paying the investment currency premium, once they purchased instruments marketed through local broker dealers and traded on the local stock exchange (BISX). The

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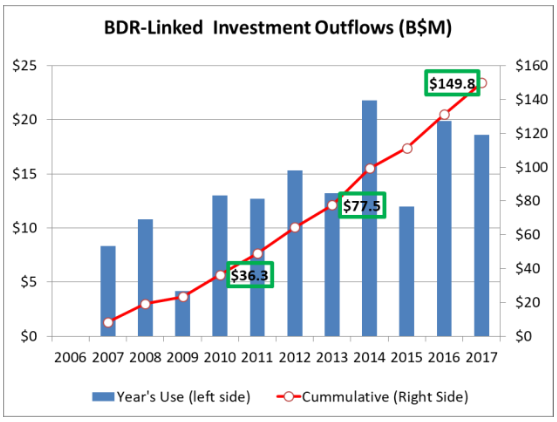
[3] This covers the ability to establish ownership in international financial institutions operating in The Bahamas, which have to be capitalised in foreign currency.
[4] The relaxed measures are published in the following report on the Central Bank's website: http://www.centralbankbahamas.com/download/013616000.pdf
[5] Borrowing from the private sector arms of the IDB or World Bank are not subject to any limit.

collective annual accommodation limit for these vehicles is now $35 million. Other portfolio transactions still incur an investment currency premium. The premium used to be at 25 percent, but was reduced to 12.5 percent in 2006 and will be reduced further to 5 percent in 2018. That said, the Investment Currency Market exists primarily to limit speculative pressures that could deplete the supply of foreign exchange and render the exchange rate unsustainable.

Figure 1: Bahamas Utilisation of Investment Currency and Stock Exchange (BISX) Linked Facilities



Note: Cumulative capital outflows for selected vehicles area as follows:- ICM: more than $50 million; BISX vehicles: $150 million; NIB: $109 million.

Source: Central Bank of the Bahamas

Another reform that has already been foreshadowed is that greater access is being opened up for residents and businesses to maintain foreign deposits accounts, but with built in protections for the exchange rate regime. In particular, business will be able to retain a portion of their foreign currency revenues to meet ongoing trade payments. Also, Bahamians who have accumulated foreign currency assets abroad will be permitted to repatriate these and, if they desire, maintain the deposits in foreign currency. The holders of these facilities will not be able to fund them with foreign exchange that is purchased on the local market. This ensures that inflows of foreign exchange remain for the most part available for the private sector's current account needs.

A Stable, Sustainable Path to Further Liberalisation

It is the continued liberalisation of the capital account to which we should aspire in The Bahamas, to the extent that it is able to stimulate higher rates of national savings and investment and provide more diversification opportunities for local investors. The proviso is that the flows, whether inward or outward, ought to be sustainable. We ought also to be able to maintain relative exchange rate and financial stability. The Bahamas must be prepared to move in this direction only as fast as we are able to erect the appropriate safeguards around highly liquid capital flows. At the same time, we should strive to put such frameworks in place.

Compared to the present environment, the outcome for liberalisation could include the following:

- The ability of Bahamians to invest outside The Bahamas in foreign currency, absent the investment currency market premium; and the ability of non-residents to invest more freely inside The Bahamas in both long-term and short-term capital.

- The ability of residents to hold foreign currency deposits in local banks and for non-residents to maintain deposits in local currency.

- The ability for residents to borrow in foreign currency and for non-residents to borrow in local currency, irrespective of source.

These would, of course imply, no restrictions on converting into and out of Bahamian dollars.

To be sustainable, net capital inflows must be able to pay for themselves. That is, their deployment should generate enough foreign currency returns to repay both the initial inflows and the required returns on those flows. Otherwise, they could become a net drain or burden on a country's stock of foreign reserves. Now, when the decision is left to banks, there should be less of a concern about whether financing of a particular currency denomination should be given to a firm, because from a best practices or regulatory point of view, banks would be required to match their lending to the currency in which the revenues of the business are denominated.

Outside of banks and similarly regulated entities, policy makers would have to orchestrate this sustainable outcome at a national level through direct incentives or disincentives to the sectors of strategic concern. If the government lacked tools such as tax policy to influence financing behaviour, it would continue to have to rely on direct, though less efficient intervention to influence external financing patterns. This is the positon in which The Bahamas still finds itself, and will likely have to focus if we are to further optimise external financing inflows to locally owned businesses over the medium-term.

As to stability, The Bahamas must still be able to accommodate the volume and speed of capital flows, without losing control of the exchange rate or the solvency of financial institutions. Funds that move through capital markets or sit in liquid bank deposits are examples of flows that can relocate swiftly. Again, from a regulatory point of view, the risk of bank insolvencies can be suppressed, by requiring that banks do not rely on short-term foreign currency deposits inflows to finance long-term lending. Reserve requirements can also be placed on banks to reduce such tendencies and to provide some insurance against sudden outflows. That said, there could also be vulnerability to sudden outflows if, *en masse*, residents are allowed to shift out very liquid funds they hold in local currency. Faced with such developments, the exchange rate could be allowed to depreciate—that is, the price of foreign exchange could be allowed to increase. Such an outcome would not be desirable for The Bahamas.[6]

Therefore, we should be striving for an outcome, where other than for diversification residents are indifferent between holding deposits in local or foreign currency. This would be an outcome where portfolio decisions are not materially driven by speculative movements to outrace expected depreciations in the exchange rate. Among other factors,

[6] Given high import reliance, a fluctuating exchange rate would affect prices but little else, as it would not confer any competitive advantages to the economy. Instead in tourism, for example, depreciation would be offset by higher local currency costs on imported inputs, and in negotiated wages which would also respond to exchange rate generated increases in the cost of consumed goods.

speculations about whether the currency would maintain its value would depend on whether it is believed that the government was doing a credible enough job of keeping its finances in order; whether it is believed that public sector debt dynamics would be kept within a comfortable zone, or whether misaligned finances were viewed as having a credible chance of being remedied.

The monetary authority is also part of the fiscal picture. Failed public finance dynamics can show up in unchecked borrowing from the central bank and in growing gaps between local currency liabilities of the monetary authority and foreign reserves, which are held to support the currency. Central bank lending to the government can also be a source of accumulated bank liquidity, of the sort that might seek to flee the jurisdiction, if they are allowed to become mobile.

The confidence boost that a financial system would need, before opening itself unchecked to short-term financial flows would be, in a case where deficits and debts are a concern, to quiet such concerns. Deficits or debt burden need not disappear at the outset, but there has to be an anchored belief that such reduction would occur within a comfortable time frame.

At the Central Bank, we are focused on gradually reducing the amount of outstanding credit provided to the government. It will also achieve, as a side benefit, some important reduction in surplus liquidity within the banking system. Over the medium-term it is also expected that a new Central Bank Act would put stronger governance arrangements in place to continue to reduce lending to government. At the same time the public finances will have to support some of the liquidity reduction in the medium-term through direct slowdown and eventual reduction in the debt burden.[7]

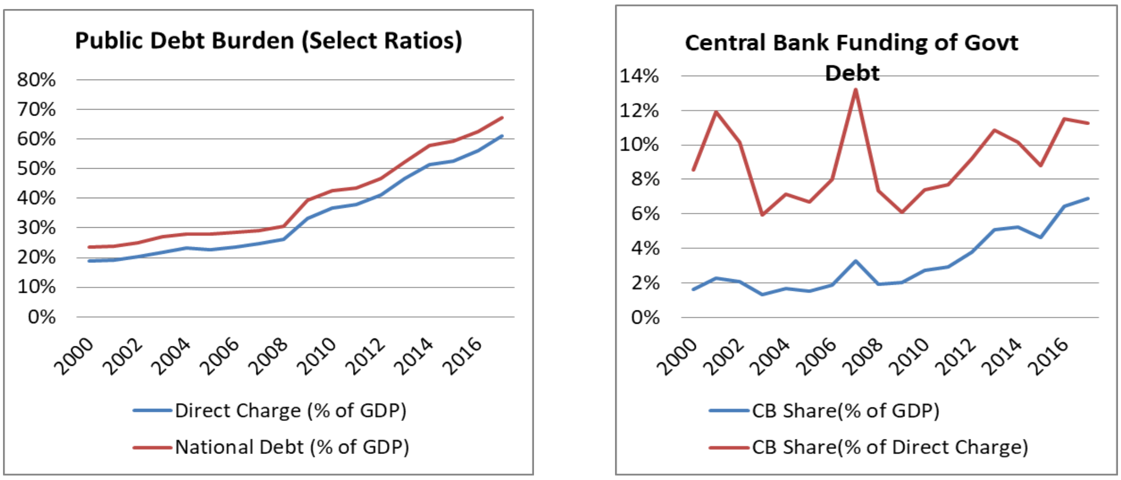
Aside from exchange control, liberalisation also has to be considered in the context of the national investment policy. If certain sectors are constrained from foreign participation, then Bahamians operating in those sectors would also be constrained in how they

[7] A costly option that many countries have taken is to have the central bank issue its own securities to soak up liquidity. However, if done aggressively the institution could incur losses.

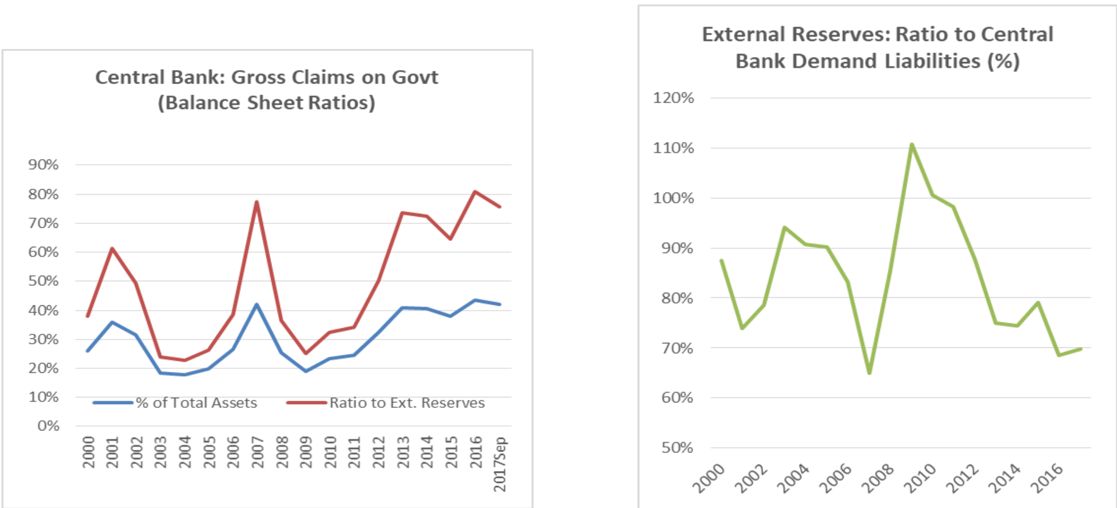
collateralise access to foreign currency financing. If majority ownership in a venture must be Bahamian, then the majority financing source, unless it is domestic would not be permissible in foreign currency.[8] Also, to the extent that restrictions apply to how non-residents acquire real estate in The Bahamas, use of such assets as security for mortgages would be subject to a layer of processing and approval that is independent of any EC rules.

Figure 2: Central Bank Financing to Government

As the government debt burden increased, reliance on central bank financing, especially over the last decade, has also increased….



The balance sheet impact for the Central Bank has been that the coverage provided by external reserves for B$ currency liabilities has declined.



Note: The Reserves to demand liabilities coverage spiked in 2009 because of the Bahamas' share of the Special Drawing Rights allocation that the IMF provided to its membership during global financial crisis.

Source: Central Bank of the Bahamas

[8] The Central Bank had to take this into account in how the 2017 liberalisation measures were framed.

The question will still come up as to how far The Bahamas should go with liberalisation, both for direct investments and portfolio transactions. The extensive work that the IMF has done has been to advise that countries should sequence liberalisation at least one step after the upgrade to institutional and policy arrangements has been made, which allow the country to optimally manage the transformed environment.[9] At the extreme, the IMF's view is that a flexible exchange rate would be ideal to allow a country to absorb the effects of large movements in short-term capital. This assumes that a country has well developed and functioning financial markets, and that the regulatory frameworks exist to ensure that financial institutions operate in a sound fashion. Adequate fiscal policy tools should also exist to incentivise the right course for the private sector. This would also mean less reliance on administrative measures, in favour of tools that affect a wider cross-section of the markets directly.[10] Being able to pre-empt adverse outcomes, which is critical, also means that sufficient capacity must exist to collect timely data to monitor private sector activities.

The Central Bank and policies affecting the banking sector are a subset of the elements in this required stronger framework. Indeed there is already progress in on the banking side. Our local banking system is sound, with the required regulatory framework, and high frequency reporting requirements to ensure safety and soundness, even if the composition of balance sheet flows were to change or become more fluid. Moreover, the Central Bank is developing expanded frameworks to monitor economy-wide indicators of financial soundness. With modernisation of the government securities market, the Bank will also have a more flexible set of tools to manage financial sector liquidity. That's said, we have to continue to improve data quality and coverage for activities outside of the banking sector.[11]

Consideration also has to be given to harmonised policies that influence other parts of the financial sector. This means progressing to a legal framework for financial stability that

[9] See The Liberalization and **Management** of **Capital Flows** - An Institutional View (IMF, 2012). http://www.imf.org/en/publications/policy-papers/issues/2016/12/31/the-liberalization-and-management-of-capital-flows-an-institutional-view-pp4720

[10] For example interest rates and tax policy.

[11] The Bahamas now aspires to meet the Special Data Dissemination Standards (SDDS) of the IMF. (See link here). This would impose more rigor on statistical systems, with more frequent and broader coverage of private sector activities.

draws in all of the other financial sector regulators, so that prudential measures, when required, have a uniform impact. Alternatively, The Bahamas needs to move to consolidate the supervision of the financial sector, at a minimum, along prudential lines.

The operating frameworks in the government sector also need more evolution, to be able to intervene in capital flows in a non-administrative fashion. As it stands, the system is still skewed towards consumption taxes. Moreover, for well into the medium-term the government's flexibility will be constrained by the necessary emphasis on fiscal consolidation.

Is Dollarisation an Option?

The working assumption is still that The Bahamas would want to avoid the nuisance of exchange rate flexibility. Reliance on other fiscal and monetary policy tools therefore becomes more important. Many have suggested that dollarisation would be an option. Giving up the B$ entirely and adopting the US currency by default would eliminate the exchange rate concern.[12] It is true that the government would no longer be able to borrow from the central bank, but it would not alter much else of what would be required in policies and frameworks to ensure stable and sustainable capital flow trends. It would not, for example, make a financial stability framework less relevant or relieve the government of the need when necessary to use fiscal policies to maintain macro-economic stability. Indeed, this outcome, if we aspire to such, would increase the imperative for good and sound fiscal frameworks.

Going the route of dollarisation also does not shorten the time required to get to a more liberalised state. The B$ currency liabilities of the central bank would still have to be extinguished at the promised rate of one-to-one. The process of deficit reduction and debt reduction therefore has to run its course. The outstanding balance of central bank lending to government would still need to be eliminated and the government entirely reliant on the

[12] A case for dollarisation could be advanced on the basis of the high structural linkages between The Bahamas on the US economy. Forgone monetary policy independence would not be a strong reason for dissuasion, however the need for policy independence could increase if the Bahamian economy were to diversify in ways that were less dependent on the US.

market and on market pricing to finance its shortfall. In fact, the government has to go much further than just eliminating its debt to the central bank. Much of the attractiveness to the private sector of holding government debt rest on the ease at which it can be sold to the Central Bank. Reliance on the central bank as the "buyer of last resort" for government debt will also have to diminish, maintaining the overall focus therefore on comprehensive debt reduction. Even a persistent balance budget rule would not outweigh expenditure prudence and efficiency. Uncompetitive high rates of taxes as a percentage of GDP would still be a recipe for capital flight.

Conclusion

To conclude, there are justifiable economic reasons to push for increased capital account liberalisation for The Bahamas. Where this process could end is much further than where the economy sits at present. However, there is no shortcut to the pre-requisite reforms to develop stronger institutions and policy frameworks, and healthier economic fundamentals. Added to how the central banking framework is strengthened, a more consolidated view of the financial sector regulations would support this outcome. Improved public finances and stronger fiscal management systems underscore the central role that the government must also play in any transformation. Finally, the speed at which we are able to reform will determine the stable and sustainable pace at which we tackle our capital controls.