

T H E C E N T R A L B A N K O F T H E B A H A M A S

R E S E A R C H D E P A R T M E N T

T H E U S E F U L N E S S O F F O R E I G N E X C H A N G E B U D G E T I N G I N T H E B A H A M A S

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October 1977

Introduction

Under the leadership of the tourist industry the economy of The Bahamas has grown at a moderate rate over the years. However, as of late, the growth rate of the economy has not been sufficient to absorb the growing labour force. Unemployment in The Bahamas is relatively high and this high rate of unemployment can only be alleviated, it appears, by the diversification of the economic base. Such diversification envisages many development projects being undertaken over the ensuing years. In common with most developing countries, the resources, real and financial, of the Bahamian economy are very limited and the implementation of any diversification of the economy will inevitably require the generation of sufficient amount of foreign exchange along with efficient use of these scarce resources. In this context, a realistic foreign exchange budgeting method which would depict the prospective inflow and outflow of foreign exchange assumes importance.

The purpose of this paper is to show how foreign exchange budgeting can be useful in a developing economy such as The Bahamas.

Section I looks at a general approach to foreign exchange budgeting. Section II gives an overview of the Bahamian economy while showing the various factors that affect the balance of payments. Finally Section III looks at the main sources of foreign exchange earnings and usages and concentrates on various instruments that could affect their performances.

Section I

Foreign Exchange Budgeting

Foreign exchange budgeting is basically an extension of balance of payments policy. In planning the development of a developing economy it is essential that the development activities of the economy be continually monitored. The purpose of monitoring such developments is to assist in the estimation of, during a specified period, the outflow of funds eventuating from the planned project which will undoubtedly require inputs such as machinery, etc. from abroad as well as those outflows resulting from other operations of the system. Also, projections of foreign exchange inflow during the same period resulting from expected capital inflows and trade along with anticipated inflow of funds due to operations of projects already completed or planned for completion during the same period should be made.

If estimated expenditures of foreign exchange exceed forecasted receipts ~~It~~ would theoretically be easy to ~~achieve~~ external equilibrium by using the various balance of payments adjustment instruments. However, even though balance of payments equilibrium is a concern, it is preferable that this be accompanied by policies that will shift the usage of foreign exchange away from activities which do not necessarily facilitate development to operations that do.

There are various policy instruments that are capable of reallocating resources by switching the use of foreign exchange from one activity to another. Under a free economy the theory of

exchange rates would prevail. This theory entails the use of two mechanisms for the adjustment to balance of payments equilibrium depending on the exchange rate regime in use. The first, known as the exchange rates approach to balance of payments adjustment, depends on the allowance of exchange rates to vary according to market conditions. The second, the income approach, would be more appropriate under a fixed-exchange rate regime and its success depends on deflationary monetary and fiscal policies. These two mechanisms cause a reallocation of resources by shifting relative prices in a system and consequently the magnitude and direction of imports, exports and capital flows.

Other options for balance of payments adjustment are those that resist to some extent the automatic response that occurs if the two mechanisms of the theory of exchange rates were used. There are three options:

1. Restrictions such as tariffs and quotas on imports and capital outflows. Also, exports can be subsidized and capital inflows induced. Such restrictions have the effect of shifting the use of foreign exchange to areas looked upon as desirable in enhancing the development of the country by giving incentives such as reduced tariffs or increased quotas on imports. Less incentive can be given to activities making little development contributions by increasing tariffs or reducing quotas on their imports.

2. Exchange Control. By using more strict exchange control regulations more foreign exchange can be retained inside the country to be used in accordance with development needs.

3. Intervention by the monetary authorities. This occurs when they enter the exchange market to enhance confidence in the currency and thus to prevent capital outflows from the system or use its reserves to finance the deficit.

For effective foreign exchange budgeting a country has to identify the components of its balance of payments. These factors can then be assessed individually in order to estimate as accurately as possible the total inflow of foreign exchange into the system and the total outflow of foreign exchange from the system. Various experiments with the balance of payments instruments may reveal a combination of tools that could improve inflows while curtailing the use of foreign exchange for unnecessary activities. This foreign exchange can, consequently, be used in desirable areas.

Once the inflow of foreign exchange has been estimated the expenditure side should be developed. In most instances the cost of desired investment will be more than the total resources available in the developing economy. Inevitably foreign borrowing ~~and~~ foreign investment will be necessary to accelerate the development process. To facilitate this borrowing, a knowledge of the various borrowing rates should be available in order that the easiest terms of borrowing may be known and used whenever possible.

Section II

Overview of the Bahamian Economy

As pointed out in Section I, factors affecting the balance of payments of a country should be recognized if an effective foreign exchange budgeting programme is to be implemented. For this reason we carefully observe the Bahamian economy pinpointing such factors.

The Bahamas is critically dependent on foreign trade in goods and services. This is evident from Table I which shows imports, exports and tourist expenditures as a percentage of GNP for the years 1969-1972.

It should be noted that no official GNP figures exist for The Bahamas, the figures used in Table I are World Bank guesstimates. It is very possible that such figures may be overestimated and therefore understate the significance of the variables being observed in Table I. Despite, this, Table I shows the extent of the reliance of the Bahamian economy on imported goods and services and on tourism to finance these needs. On average imports and tourist expenditures, as a percentage of GNP, accounted for over 65% and 62% respectively.

Exports averaged 13.7% of GNP over the period. This may seem very impressive for an economy lacking in natural resources like The Bahamas. However, exports result largely from offshore operations whose products are normally restricted in the local markets. Being foreign owned these companies' export receipts do not necessarily reflect an inflow of foreign exchange since these receipts are normally repatriated if they ever enter the country at all.

Table II shows domestic food production as a percentage of total food requirement for the years 1969-1973. On average the Bahamian economy has produced less than 17% of its food needs during this period. With over 80% of its food requirement imported, an opening for import substitution does exist in this sector.

On observing Table III which shows employment by type of industry for the year 1975, it is clear that the concentration of economic activity centres round the tourist sector. Restaurants and hotels and community, social and personal services accounted for 39.7% and 15.7% of total employment respectively. In the primary, mining and quarrying and manufacturing sectors the contributions to employment were 8.2%, 1.2% and 1.8% respectively.

As pointed out earlier, the bulk of the receipt from exports of goods result from offshore operations. These operations fall mainly in the mining and quarrying and manufacturing sector with relatively significant activity in the agricultural sector. These operations may not contribute significantly in terms of output for the economy but they do assist the foreign exchange earning of the country via employment, and they also account for a substantial portion of imports.

With tourism being the biggest earner of foreign exchange for The Bahamas and with almost a total reliance on food and other goods from abroad, it is easy to accept the realism that the economic performance of the Bahamian economy is subject to the cyclical and seasonal gyration experienced by countries from which its tourists emanate.

Table IV lists the number of tourist arrivals, both air and sea, for The Bahamas for the years 1964-1976. Table V gives a percentage breakdown of arrivals by residency for the years 1963-1973. From Table V it is revealed that on average the U.S.A. supplied over 84% of total arrivals followed by Canada with slightly less than 8%.

It is also likely that small contractions in the U.S.A. and Canadian economies can have magnified effects on peripheral economies such as The Bahamas, a case in point being the recessionary period of 1974-1975 experienced by the industrial economies. This slowdown in economic activity in the North American economies due to the energy shortage seriously affected the tourist trade in The Bahamas. From Table IV we observe a decline in tourist arrivals for the years 1973 and 1974 of 8.7% and 0.5% respectively. This caused a large number of workers to be laid off. Furthermore, unemployment in The Bahamas has worsened primarily as a result of tourism not catching up to its pre-1973 performance.

~~The~~above situation becomes more intense~~when~~ when we realize how important the role of tourism has emerged for many countries that desire to boost their sagging economies. Competition has become more keen between countries. Even in the U.S.A. where the bulk of The Bahamas' tourist emanate, developments, with an attempt to lure more of its residents away from areas like The Bahamas to places such as Atlantic City and Miami Beach, are in the making.

The introduction of casinos is being considered, subject to legislative approval, in both Atlantic City and Miami Beach. The

recent ruling on conventions held outside the U.S.A. under the U.S. Tax Reform Act, 1976 could prove a burden on the Bahamian economy. Also, with the restrictions on American entering Cuba being dropped by the American Government some skepticism should be generated on the ability of The Bahamas to attract the number of tourists it has been used to, and is now experiencing, in the near future.

Furthermore, the population of The Bahamas is a growing one. It has been predicted by the Department of Statistics that the growth rate will double by 1985. The growth of the tourist sector would have to occur at an increasing rate - which does not appear possible given the above developments - or The Bahamas economy will have to receive a boost from other activities if the increasing population and labour force is to be accommodated.

With the anticipation that tourism may well fall off there is a belief that the area that would assist The Bahamas greatly would be banking mostly because offshore banking is of some importance at the present time in The Bahamas and has the potential to become more important in the future years.

Banking and other financial activity is presently responsible for, roughly, about 15% of the employed force. The economy of The Bahamas obtains a significant amount of foreign exchange from offshore banking operations.

However, offshore banking is a volatile activity. These operations exist in The Bahamas primarily as a result of the tax haven status. Such banks contribute to the foreign exchange receipts

of the system but have the ability to shift their operations elsewhere on very short notice if there exists or there is a belief that there will develop any economic and/or political environment that is adverse to their functioning. Furthermore, conditions in The Bahamas may remain constant and very favourable to these operations but, in the meanwhile, through competitive forces, other countries may be in a position to grant more favourable terms inevitably enticing such operations out of the system. For this reason it is important that the authorities carefully observe the world developments in offshore banking in order that corrective measures can be instituted whenever necessary.

Tourism and banking and financial activity constitutes a very high percentage of the economic activity in The Bahamas. Sectors such as agriculture and fisheries, manufacturing and mining play a minor role.

For the agricultural sector, government appeared quite content to have the above process continue as evidenced by the annual budgetary appropriation to the Ministry of Agriculture for the years 1969-1973. Table VI shows that as a percentage of total government expenditure these appropriations averaged 1.5% over the period. However, there is now a realization by government of the consequences of such a dependency on external factors and, consequently, some effort is being made to remedy the situation.

This effort is manifested in a government supported economic diversification programme that gives priority to the agriculture and fisheries sector. Light, heavy, and argo-industry

are also emphasized. The development of these sectors can assist in import substitution thus preserving some foreign exchange to further assist in the development of these sectors. Such changes should not be done with the intention of crowding out tourism or reducing offshore activity but with the intention of complementing these areas. These areas, especially tourism, will continue to be the leading foreign exchange earning activity and may remain that way even after the diversification exercise is completed.

In order for the development of the economy to become a reality, foreign exchange will be needed. The government will have to play a leading role in determining the direction of the economy, either by providing incentives to private concerns in the areas it considers desirable for the development of the economy, and/or by directly involving itself. Offshore, exporting operations should be encouraged since these operations import practically all of their machinery and inputs but provide foreign exchange to the country in the form of employment.

Section III

Policy Measures and Sources of Inflows and Outflows

The main sources of foreign exchange earnings for The Bahamas, apart from inflow of foreign aid and loans are: tourism, local expenditures of offshore operations, exports and investment income of the central bank. The main uses of foreign exchange are imports and factor payments.

Part I of the paper listed various policy instruments capable of being used to correct balance of payments disequilibrium. Since the development of certain sectors of The Bahamas economy, e.g., the primary sector and light industry, is of primary concern. These policy instruments can be used whenever there are expected balance of payments deficits so as to shift the use of foreign exchange to these sectors.

Again these instruments are: the two mechanisms of the theory of exchange rates, the exchange rates approach and the income approach, which produce an automatic response and the three options, restrictions, exchange controls and intervention, which resist the automatic response.

Given the nature of the Bahamian economy, exchange rate adjustments on the Bahamian currency relative to other currencies would be inappropriate as there would be no positive balance of payments results (unless there are realized restrictions on wage increases). With such a high propensity to import and with no local alternatives, it is reasonable to assume that prices would increase

proportionally to a reduction in the exchange rate. This would not change the cost of goods and services in terms of foreign currencies and therefore, not affect the tourist or export sector.

The income approach appears to be the better of the two automatic responses. Maintaining a high interest rate policy will curtail, to a certain extent, unnecessary import demand and lead to a choice of more realistic (i.e., more viable) projects both by government and private sector and thereby conserve foreign exchange. High interest rates would also act as an inducement to foreign investment. Also, preferential interest rates can be used to assist desirable areas such as agriculture and fisheries and light industry.

Turning to the non-automatic options, restrictions and intervention are seen as useful while more strict exchange controls is not.

The reason for excluding more strict exchange control regulations is that The Bahamas, being a signatory to Article VIII of the Articles of Agreement of the IMF, has an obligation to avoid restrictions on current payments and discriminatory currency practices and therefore will not introduce exchange controls contrary to this agreement.

Intervention can be useful. However, in a developing economy it is not the usual practice and often impossible for the monetary authorities to finance imbalances by buying or selling spot exchange or intervening in the financial and exchange markets to produce movements of short-term capital. It is useful in the sense that the central bank in The Bahamas can use a portion of its reserves

to finance the deficit in the balance of payments or budget for use of such reserves if there is an estimated deficit. This, however, depends on the policy goals of The Central Bank of The Bahamas and its rationale for holding foreign reserves.

Restrictions can take the form of tariffs and quotas placed on imports of goods and services. This, while restricting the use of foreign exchange for importing goods affects, gives an incentive to domestic industries producing these goods and preserves foreign exchange for the development of these industries. Incentives can also take the form of subsidies on certain export activities. But tariffs, quotas and subsidies, unless properly used, may lead to distortions in the economy and produce further imbalances.

As pointed out in Section II, the offshore activities, banking and other industries, in The Bahamas should be encouraged. Furthermore, incentives, taxes and others, should be extended to foreign investment to increase activity in this area.

Conclusion

The paper attempts to show how foreign exchange budgeting can assist in developing specific sectors in the Bahamian economy. The basic problems of the economy are discussed and consequently the need for foreign exchange budgeting.

As there has been no method of foreign exchange budgeting in The Bahamas previously it is very difficult to determine the efficacy of the various suggestions made.

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TABLE I
IMPORTS, EXPORTS AND TOURISM EXPENDITURES
AS A PERCENTAGE (%) OF GNP, 1969 to 1972
(CURRENT VALUES)

\$ Million

Year	(1) GNP at Market Prices	(2) Imports ^a	(3) (2) as a % of (1)	(4) Exports ^b	(5) (4) as a % of (1)	(6) Tourism Receipts	(7) (6) as a % of (1)
1969	393.9	302.3	75.6	53.8	13.4	235.5	58.9
1970	400.5	298.4	74.5	57.6	14.4	230.1	57.4
1971	409.7	247.8	60.5	41.3	10.0	274.8	67.1
1972	414.5	258.0	52.2	70.2	16.9	282.6	68.2

a - excludes oil and related products imported for refining and re-export; the figures, however, do include an estimate for domestic consumption.

b - excludes oil and related products; the 1969 and 1970 figures include a small re-export element.

SOURCE: Table 1.2; Quarterly Review, June, 1974, CBB;
BMA Annual Report, 1972.

TABLE II

DOMESTIC FOOD PRODUCTION AS A PROPORTION
OF TOTAL REQUIREMENTS, 1969 TO 1973

U.S. \$'000	(1) Total Food Imports	(2) Estimated Domestic Production	(3) Total Food Requirements (1) + (2)	(4) (2) as a % of (3)
Year				
1969	48,050	9,100	57,150	15.9
1970	47,620	9,490	57,110	16.6
1971	56,249	9,987	66,236	15.1
1972	59,500	11,100	62,600	17.7
1973	59,500	11,500	71,000	16.2

SOURCE: Annual Report of the Ministry of Agriculture
and Fisheries, 1971. Special Requests.

TABLE III EMPLOYED PERSONS BY TYPE OF INDUSTRY AND BY NATIONALITY: 1975: ALL BAHAMAS

INDUSTRY	TOTAL EMPLOYED	PERCENT
Agriculture and Fishing	5,412	8.2
Mining and Quarrying	769	1.2
Manufacturing	1,219	1.8
Gas, Electricity and Water	1,849	2.8
Construction	2,283	3.4
Wholesale and Retail Trade	7,784	11.7
Restaurants and Hotels	10,451	15.7
Transport, Storage and Communications	5,167	7.8
Financing, Insurance and Real Estate	4,839	7.3
Community, Social and Personal Services	26,357	39.7
Unknown	288	0.4
TOTAL	66,418	100.0

SOURCE: Labour Finance Report 1975
 Department of Statistics

TABLE IV TOTAL TOURIST ARRIVALS

Period	Air	Sea	Total	% Change In Total
1964	364,611	240,560	605,171	-
1965	440,338	280,082	720,420	19.0
1966	549,423	272,894	822,317	14.1
1967	649,388	265,885	915,273	11.3
1968	818,994	253,219	1,072,213	17.1
1969	970,325	362,071	1,332,396	24.3
1970	916,479	381,856	1,298,335	-2.6
1971	970,965	492,626	1,463,591	12.7
1972	1,044,973	466,885	1,511,858	3.3
1973	1,021,842	489,165	1,520,007	0.5
1974	966,555	421,483	1,388,038	-8.7
1975	917,520	463,340	1,380,860	-0.5
1976	953,929	449,712	1,403,641	1.6

SOURCE: Ministry of Tourism Annual
Report and Monthly Visitor
Reports.

TABLE VTOTAL VISITORS BY POINTS OF RESIDENCE,
1963 to 1973 (Percentage)

Years	U. S. A.	Canada	U. K.	Western Europe	Rest of the World	Total
1963	82.2	12.0	2.2	-	3.6	100.0
1964	80.4	11.8	2.8	-	5.0	100.0
1965	77.9	10.4	4.5	-	7.2	100.0
1966	82.5	9.4	3.0	-	5.1	100.0
1967	87.0	6.5	2.3	-	4.2	100.0
1968	87.0	6.0	1.7	1.2	4.1	100.0
1969	87.5	5.1	1.4	1.5	4.5	100.0
1970	87.4	4.5	1.3	2.0	4.8	100.0
1971	87.8	5.2	1.2	1.4	4.4	100.0
1972	86.3	7.3	1.2	1.7	3.5	100.0
1973	84.0	8.8	1.3	2.4	3.5	100.0

SOURCE: 1973 Annual Report of the
Ministry of Tourism.

TABLE VI

ANNUAL BUDGETARY APPROPRIATION TO THE MINISTRY OF AGRICULTURE

Year	(1) Current	(2) Capital	(3) (1) + (2)	\$'000 (4)
				(3) as a % of Total Expenditure
1969	512	129	641	0.8
1970	953	362	1,315	1.3
1971	1,840	399	2,239	2.4
1972	882	259	1,141	1.2
1973	696	358	1,054	1.0

SOURCE: Official Estimates; Quarterly Reviews, CBB.

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