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CENTRAL BANKING IN THE BAHAMAS

By

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The Bahamian economy is predominantly service-oriented. Next to tourism, banking and finance is the most important industry accounting for some 15% of the Gross Domestic Product which is defined as the total value of goods and services produced in an economy. A mature and strong financial infrastructure is a sine qua non for economic growth and development and in this regard The Bahamas is a step ahead of many developing countries insofar as our dynamic banking and financial sector provides a source of financing to the public sector which is the major agent for advancing economic growth and development.

The Central Bank, as the premier financial institution, is entrusted with the responsibility of formulating and conducting monetary policy on behalf of the Government by exercising discretionary control over the monetary and financial system. Monetary policy plays a very important role in the process of economic growth and development and the Central Bank is empowered with various tools of monetary and credit control which can be applied singly or in combination to achieve various policy objectives such as a stable rate of economic growth; a high level of employment; stability in the purchasing power of the local currency and a viable balance of payments position. This article will essentially be concerned with the operations of the Central Bank as it relates to the domestic banking system. However, it will also examine the Bank's relationship with the offshore banks as this is a unique feature of central banking in The Bahamas.

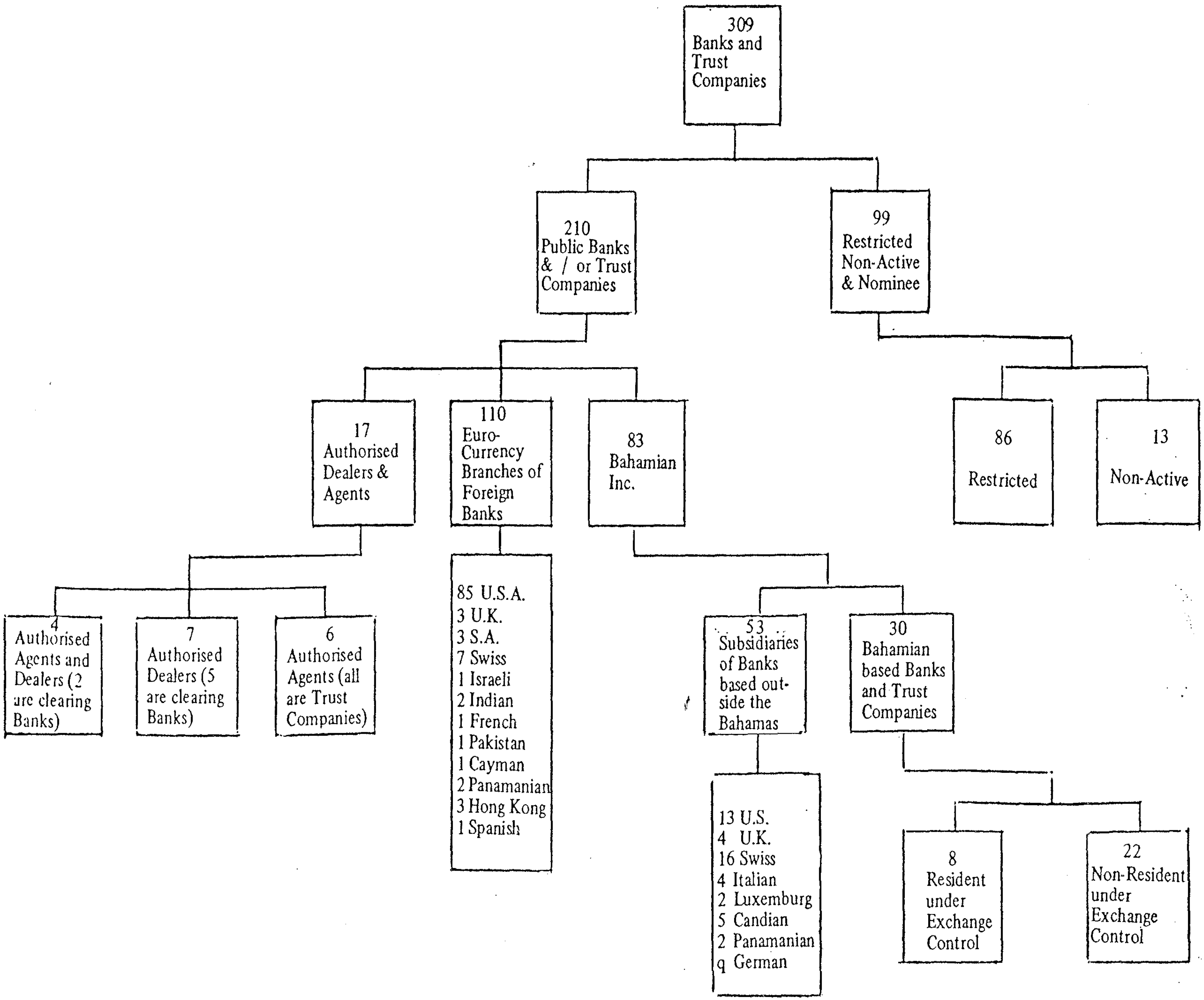
The paper will be organized along the following lines. The structure of the financial system will be discussed briefly in Section I. In Section II we will outline the various tools of monetary and credit control available to the Central Bank. Section III will look at the practical steps that have been taken by the Central Bank to effectively segregate the domestic banking system from the offshore banking sector so as to prevent any possible frustration of the Bank's monetary policy objectives from the latter source. Section IV will review the monetary policy measures adopted by the Central Bank in 1980 in an effort to ease the pressure on the country's foreign exchange reserves. Section V will conclude with a discussion of the more recent policy instruments used by the Bank to bolster the supply of foreign reserves and to curtail the growth in credit since in an open economy such as ours any expansion in credit will lead directly to an increased demand for imports, hence a worsening of the balance of payments as reflected in a loss of international reserves.

I. The Structure of the Financial System

The first financial institution in The Bahamas was established in 1835 as a Government Savings Bank. In 1837, it expanded its functions to include commercial banking services and it was formally changed to the Public Bank of The Bahamas. In 1889, the Bank of Nassau was formed. This became insolvent during the first World War and its assets and liabilities were acquired by the Royal Bank of Canada which came into existence in 1908. This was the only commercial bank operating in The Bahamas until 1947 when Barclays Bank came to our shores. The banking industry experienced a remarkable growth in the sixties with the setting up of several branches and/or subsidiaries of foreign banks when The Bahamas gained recognition as a centre for Euro-dollar trading and later with the boom in offshore trading. In 1963, there were only 37 banks and trust companies. This number increased to 208 by the end of December 1967. At the end of 1970, there were 307 and on December 31, 1973 the number of licensed financial institutions in The Bahamas totalled 323. Of the 323 financial institutions licensed under The Banks and Trust Companies Regulation Act 1965, 133 of these were non-active or restricted to deal with the person or persons specified in the licence and 190 were licensed to deal with the general public. Of these 190, there were 107 Euro-currency branches of foreign banks which engaged exclusively in offshore operations.

Chart I gives a detailed breakdown of the financial system as of September 30, 1980. Of the 210 financial institutions licensed to transact business with the general public, 110 are Euro-currency branches of foreign banks, 83 are Bahamian incorporated banks and/or trust companies and the remaining 17 are authorized dealers and/or agents'. Of these 17 financial institutions, twelve are commercial or domestic banks. The unique feature of the banking system in The Bahamas is its duality with respect to domestic banking vis-à-vis offshore banking. In addition to the strictly offshore banks, the domestic banks as well as some of the incorporated banks conduct extensive offshore operations. In fact, the offshore assets and liabilities of the domestic banks are far in excess of their domestic assets and liabilities.

CHART I: BANKS AND TRUST COMPANIES LICENCED IN THE BAHAMAS AS AT SEPTEMBER 30TH 1980.



The Central Bank was established on June 1, 1974 under The Central Bank of The Bahamas Act. As the principal financial institution, it was vested with numerous responsibilities, the most important being that of formulating and operating monetary and credit policies. The broad objectives of the Bank as outlined in Section 5 of The Central Bank Act are:

(a) To promote and maintain monetary stability and credit and balance of payments conditions conducive to the orderly development of the Bahamian economy;
(b) In collaboration with the financial institutions, to promote and maintain adequate banking services and high standards of conduct and management therein; and
(c) To advise the Minister of Finance on any matter of a financial or monetary nature referred by him to the Bank for its advice.

In this regard, The Central Bank of The Bahamas is no different from the other Central Banks in the region. Like its counterparts, it has been entrusted with sufficient powers and functions to facilitate the realization of these objectives. The Central Bank is the sole issuer of notes and coins; it acts as a banker and adviser to the Government and manages the Government's debt; it is also a banker and lender of last resort to the commercial banks. For regulating the supply of money and credit in the banking system, the Central Bank has all the conventional policy instruments at its disposal. These will be discussed in the next section.

As manager of the public debt, the Central Bank meets the government's need for short-term borrowing by making temporary advances in amounts not exceeding 10 per cent of government's ordinary revenue receipts. With respect to long-term finance, the Central Bank arranges for the issue of Government's Registered Stocks and provides a market for these Stocks. The Bank decides how much of the varying types of maturities it should incorporate in its assets portfolio for future sales to institutional investors and also for its credit policy operations. The Central Bank Act restricts the Bank by limiting its holdings of securities maturing beyond five years to 20 per cent of its demand liabilities. However, there is no limit on the holding of Government securities maturing within five years. In executing its operations relating to the floatation of Registered Stocks, the Central Bank ensures that such operations have the least disturbance on the money market and the Government securities market. It also ensures that the Government can raise the long-term loans it needs on the most favourable terms.

II. Monetary Policy Tools in The Bahamas

The instruments of monetary and credit control available to th Central Bank are the variable reserve ratio; variable liquid assets ratio; discour rate which is the rate at which the Central Bank lends to commercial banks selective credit control under which the Central Bank instructs the banks tc allocate more credit to the priority, production-oriented sectors such a agriculture and small businesses; open market operations which is concernec with the purchase (sale) of Government bonds by the Central Bank from (to) commercial banks in order to increase (decrease) the supply of banks loanable funds. Finally, there is moral suasion which is essentially a gentleman's agreement between the Central Bank and the commercial banks whereby the latter consent to abide by the guidelines set by the Banks with regards money and credit. The Governor meets periodically with the bankers to discuss such matters.

In its transactions with the domestic banks the Central Bank attempts to regulate both the assets and liabilities of the banks so as to affect the monetary base[2] and hence the Bank's ability to expand credit. The Central Bank uses the discount rate instrument to control the assets of the commercial banks. The Bank charges commercial banks a rate which is ½ per cent above the average market rate of discount of Treasury bills for the rediscounting of Treasury bills. Loans and advances are made to commercial banks against the security of Government Registered Stock and other eligible securities for a period not greater than the maturity date of the security or 93 days, whichever is longer, at a rate of ½ of one per cent above the prime rate, which is the rate at which banks lend to their best corporate customers. The amounts of any such loan or advance cannot exceed 85 per cent of the market value of the instrument at the date of its acquisition by the Bank. Informal arrangements exist between the monetary authorities and commercial banks whereby the authorities stand ready to purchase Government securities from the banks at face value to encourage them to hold the securities. However, some commercial banks still have no Government securities in their asset portfolio, hence they cannot avail themselves of accommodation facilities from the Central Bank.

With regards the banks' liabilities, a reserve ratio has been set at 5 per cent of Bahamian dollar deposit liabilities for all banks since July 1974. This represents the amount of till cash and balances that banks must hold with the Central Bank as reserves against their Bahamian dollar deposits. The authorities also have the power to vary the liquid assets ratio between 10 per cent and 30 per cent but since July 1974 this ratio has been fixed at 20 per cent of demand deposits and 15 per cent of time and savings deposits. Eligible liquid assets include notes and coins; balances with the Central Bank; treasury bills and other Government securities; net balances with financial institutions in The Bahamas; bills of exchange and any other assets specified by the Bank. To date, there has been no variation in the reserve ratio or the liquid assets ratio. Both ratios serve a dual purpose namely, to ensure that banks remain sufficiently liquid to allow them to adequately meet the public's demand for cash and to facilitate the attainment of the Central Banks monetary policy objectives.

The authorities have not yet exercised the power of selective credit control and the absence of well-developed money and capital markets severely limit the extent to which open market operations can be effectively used as a tool of monetary policy. Moral suasion has been widely used and has undoubtedly been the most effective tool in the past. However, recent developments have forced the authorities to adopt more direct measures of monetary and credit control in order to protect the economy against the vagaries of external forces.

III. The Central Bank's Relationship with Offshore Banks

Before we examine the Central Bank's relationship with the offshore banks, we must be perfectly clear in our minds as to what we understand by the concept "offshore". Contrary to the widely held view of The Bahamas as an international financial centre, The Bahamas does not perform the function of an international financial intermediary such as London, New York, Zurich, Paris, Hong Kong, etc. The Bahamas provides offshore banking services. The funds flowing into The Bahamas are not converted into Bahamian dollars. They are mostly Euro-dollar transactions which originate from the Head Office of banks located in foreign countries or from other branches and the Nassau branches act as administrative and accounting centres for such transactions. The absorptive capacity of The Bahamas is relatively low and, bearing in mind the investors' desire for liquidity, one can readily appreciate why centres such as Nassau merely act as conduits. Although, by and large, these Euro-currency banks act as administrative and accounting centres, a recent trend has been for the Euro-currency banks themselves to float debenture bonds from their Nassau office. The substantial stamp duties derived from these bonds constitute a direct advantage to the local economy.

The Central Bank of The Bahamas, like other Central Banks in the region, has the responsibility of maintaining domestic monetary stability and equilibrium in the balance of payments. However, unlike its counterparts in the region, it has the added responsibility of strengthening the offshore banking structure in the interest of the national as well as the international community. The Central Bank must ensure that the reputation of Nassau as an offshore banking centre is maintained so that world confidence in international banking cannot be shaken as it was in the seventies with the failure of the Franklin National Bank, the Herstatt Bank, the International Credit Bank of Geneva and a few other Swiss banks which led to a step-up in the supervision of the international banking system.

Although the Central Bank does not intend to tighten its control on the offshore operations of bank branches in The Bahamas, it must always be aware of developments on the international scene. Failure of offshore banks here will undoubtedly have a damaging effect on international banking. Consequently, the Central Bank has been carefully monitoring offshore banking activities in accordance with The Banks and Trust Companies Regulation Act 1965. The Bank's Supervision Department adheres to very strict rules in assessing the applicants' character, integrity and the capability of directors and managers. The Central Bank is guided by certain fundamental principles in allowing offshore banks to operate. Although they are permitted to operate in virtual freedom from official control, The Banks and Trust Companies Regulation Act 1965 preclude a bank from functioning in a manner that would damage the reputation of The Bahamas as a successful offshore banking centre. A development during 1977 was the formation in The Bahamas of a Group of Euro-banking Institutions to serve as a forum for more meaningful dialogue between the Euro-dollar banks and the Central Bank. The Group would also act as a medium for channelling information to its participants. This Group has proved to be a very useful medium for Euro-currency affairs. This formal approach in addition to an informal arrangement based on mutual trust and understanding with each bank has contributed to the development of Nassau as a reputable offshore banking centre.

The question that usually comes to mind when dealing with offshore financial centre is whether or not it is possible to insulate the economy from the operations of the offshore banks. In the case of The Bahamas, the Central Bank has been quite successful in segregating the domestic banking business from the offshore activities. In a situation of tightness in the local money market, Exchange Control Regulation precludes the offshore banks' infiltration into the market for the profitable employment of their funds. Similarly, if there is excess liquidity in the domestic market, the local financial institutions cannot deposit excess funds with the offshore banks because the latter needs official approval to hold Bahamian dollars. In short, Exchange Control Regulations prevent the offshore banks from conducting their business in a manner that would frustrate the Central Bank's monetary and credit policy.

The Central Bank's success in insulating the domestic banking operations from the offshore banking sector is due to its flexible Exchange Control system. Offshore banks are designated "non-resident"[3] and they operate without restrictions in the international transactions. But the Central Bank's approval is required for any dealings in Bahamian dollars. Resident banks[4] who are authorized to deal in foreign currency may borrow foreign currency without limit for relending abroad but they need the Central Bank's approval to make foreign currency loans to residents. Under the Exchange Control Regulations, residents are generally not allowed to hold foreign currency accounts. However, in some cases approval is given for the holding of such accounts mainly for commercial purposes.

Of greater import are the restrictions relating to the switching into and out of Bahamian dollars. Resident banks are allowed to maintain a $500,000 long or short open position, that is, their foreign currency liabilities (assets) must not exceed their foreign currency assets (liabilities) by this amount. Any amount in excess of this limit must be submitted to the Central Bank in exchange for Bahamian dollars. This quantitative limit is imposed by the Central Bank to ensure that banks provide cover for their Bahamian dollar liabilities with adequate levels of Bahamian dollar assets. It also attempts to prevent speculation in Bahamian dollars against other currencies as well as to ensure that Bahamian dollar deposits are utilized for Bahamian dollar loans and advances. The existence of a Euro-currency market as a parallel source of funds for the banks does not jeopardise monetary policy as in other countries which permit an arbitrary switching into and out of local currencies.

IV. Monetary Policy Measures Adopted by The Central Bank in 1980

Although the country's foreign exchange reserves registered a surplus of $19.4 million in 1979, the rapid expansion in the private sector demand for Bahamian dollar credit, which began in 1978 and gained momentum in 1979 in the wake of the widening interest rate differential between Euro-dollar rates and local lending rates (see Table I), continued well into 1980. This coupled with increased outflows under interest, dividends and profits and other payments on the capital account exerted considerable pressure on the balance of payments in 1980. It was observed that much of this credit was used for inventory build-up. Also with the rise in the cost of foreign credit, suppliers credit became increasingly difficult to obtain thus further increasing manufacturers' demand for Bahamian dollar credit. Also import prices were rising owing to higher inflation abroad. The Central Bank adopted several measures aimed at curbing this sharp expansion in Bahamian dollar credit to relieve the pressure on the country's foreign exchange reserves. Commercial banks liquid assets position was closely monitored to ensure that they were complying with their statutory requirements and they were asked to refrain from selling Government securities to the Central Bank. Exchange Control approvals for prepayment of foreign currency loans were terminated and banks were encouraged to reduce loans to importers for financing inventories.

TABLE 1

Loans and Advances of Commercial Banks1/

	Total	In Foreign Currency	In Bahamian Dollars	Proportion of Foreign Currency Loans	Interest Rate Spread 2/
	(In millions of Bahamian dollars)			(In percent)	
1976 – IV	270.3	96.7	173.6	35.8	4.2
1977 – I	264.2	93.9	171.6	35.5	4.4
II	274.6	97.0	177.6	35.3	3.9
III	297.5	115.5	182.0	38.8	3.3
IV	306.6	119.3	187.3	38.9	2.4
1978 – I	299.1	116.4	182.7	38.9	2.2
II	319.1	129.5	189.6	40.6	1.7
III	323.3	127.0	196.3	39.3	0.8
IV	327.8	120.0	207.7	36.6	– 1.6
1979 – I	325.0	113.2	211.8	34.8	– 1.4
II	332.9	108.2	224.7	32.5	– 1.1
III	347.4	107.2	240.2	30.9	– 2.7
IV	362.1	96.9	265.2	26.8	– 5.7

SOURCE: CENTRAL BANK OF THE BAHAMAS

1/ Excludes loans and advances to the Government

2/ Percentage point difference between prime rate on Bahamian dollar loans and 3 - month Euro-dollar rate.

Although it was anticipated that these measures would help to reduce the pressure on the foreign exchange reserves, the authorities recognized that unless the local lending and deposits rates were raised to a more competitive level to discourage further shifts in the currency mix of the public's financial assets and liabilities, the liquidity position of the commercial banks would continue to deteriorate. Interest rates in The Bahamas have remained relatively stable in recent years (see Table II). Savings deposits rates have remained on average around 4.75 per cent while rates on fixed deposits have generally declined since early 1976. The prime rate has remained fixed at 9.5 per cent until April 1979 when it was reduced to 9.0 per cent. The Central Bank, being cognizant of the adverse impact that an unadjusted deposit rate could have on commercial banks resource base as savers opted for investing abroad, moved quickly to deal with the situation. In February, 1980, the Clearing Association, in concert with the Central Bank, raised the prime rate and the savings deposits rate by 2 percentage points from 9 per cent to 11 per cent and from 4 per cent to 6 per cent respectively. Concurrently, the Central Bank raised its discount rate by a similar amount from 9 per cent to 11 per cent. However, developments during the first six months of 1980 were by and large discouraging particularly the slowdown in the growth of deposits and the continued expansion in Bahamian dollar credit to the private sector which together brought increasing pressure to bear on commercial banks liquidity. Total Bahamian dollar deposits for the first six months of 1980 totalled $15.5 million compared with $27.7 million for the corresponding period in 1979. While Bahamian dollar credit to the private sector for the same period stood at $25.3 million as against $17.1 million for the same period in 1979.

TABLE II

Bahamas: Selected Interest Rates

(Quarterly average, in per cent per annum)

	1976				1977				1978				1979			
	Qtr. I	Qtr. II	Qtr. III	Qtr. IV	Qtr. I	Qtr. II	Qtr. III	Qtr. IV	Qtr. I	Qtr. II	Qtr. III	Qtr. IV	Qtr. I	Qtr. II	Qtr. III	Qtr. IV
Deposit Rates 1/																
Savings deposits	4.60	4.60	4.65	4.73	4.74	4.74	4.49	4.74	4.74	4.59	4.50	5.20	4.90	4.50	4.72	4.46
Fixed deposits																
Up to 3 months	7.05	6.89	6.42	6.52	6.60	5.56	5.56	5.69	5.48	5.71	4.95	5.06	5.10	4.87	4.83	4.62
Up to 6 months	7.63	7.03	6.85	7.00	6.96	6.16	6.16	6.11	5.95	5.99	5.60	5.66	6.28	5.48	5.47	5.12
Up to 12 months	7.90	7.40	7.25	7.46	7.21	6.60	6.60	6.26	6.20	6.24	5.88	6.02	6.03	5.89	5.71	5.64
Over 12 months	8.21	7.87	7.62	7.88	7.78	7.01	7.00	6.88	6.73	6.80	6.25	6.79	6.17	6.21	6.28	6.19
Lending Rates 1/																
Commercial Bank																
Prime rate	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.50	9.00	9.00	9.00
Mortgages																
Residential	12.07	12.05	12.20	12.18	12.16	12.14	12.13	12.13	12.13	12.12	12.04	11.86	12.05	11.19	11.80	11.86
Commercial	12.12	12.11	12.11	12.10	12.10	12.11	12.10	12.11	11.71	11.75	11.77	11.83	12.03	11.86	11.64	11.53
Consumer Loans																
Hire-Purchase	17.17	17.17	17.17	17.17	17.17	17.17	17.17	17.67	17.67	17.67	17.17	17.17	17.17	16.72	16.72	16.72
Other	16.24	16.20	16.30	16.26	16.30	16.32	16.30	15.82	15.82	15.79	15.79	15.49	15.43	15.04	15.04	15.04
Other Rates in the Bah. 1/																
Treasury Bill Rate	6.06	3.65	4.68	6.85	6.82	3.70	3.77	5.39	4.55	3.28	3.08	2.93	3.30	2.18	2.66	4.14
Central Bk. Rediscount Rate	6.56	4.15	5.18	7.36	7.32	4.20	4.27	5.89	5.05	3.78	3.58	3.43	3.80	2.69	3.16	4.64
Euro-dollar Rate (London) 3 - month deposits	5.54	5.86	5.68	5.25	5.11	5.56	6.21	7.11	7.28	7.84	8.71	11.08	10.87	10.62	11.66	14.70

SOURCE: Central Bank of the Bahamas; and *International Financial Statistics*

1/ In Bahamian dollars.

The Central Bank moved to ease the pressure on liquidity by making direct loans to banks against the security of Government securities. Those banks which were not eligible to borrow from the Central Bank owing to lack of the required collateral were forced to borrow on the interbank market.

V. Conclusion

A disconcerting development during 1980 was the marked step-up in interbank foreign currency transactions and the concomitant reduction in commercial banks sales of foreign exchange to the Central Bank which further intensified the pressure on the country's international reserves. While Exchange Control Regulations permitted banks to deal among themselves in foreign currency, there has been a tacit understanding between the banks and the Central Bank that any foreign balances in excess of the current requirements of the holders of these accounts (mainly the hotels) should be sold to the Central Bank for Bahamian dollars. Indicators were, however, that commercial banks were selling these excess balances in the interbank market at a rate above par.

While the Central Bank did not want to completely withdraw the right given to commercial banks to deal among themselves in the interbank market, the Bank took steps to ensure that they would not abuse this privilege at the expense of the country's international reserves. With this in mind, the Central Bank sought to limit the amount of interbank foreign currency dealings by requiring that banks report all interbank foreign currency transactions in excess of US$250,000 to the Central Bank. Also, in order to compete more effectively with commercial banks and increase the inflow of foreign exchange to the Central Bank, on September 11 the Central Bank altered its buying and selling rates for U.S. dollar balances from the banks to US$1.0000 = Bah. $1.0025 up from the previous par rate of US$1.0000 Bah.$1.0000. The selling rate was lowered from US$1.0000 = Bah.$1.0050 to US$1.0000 = Bah.$1.0040 to make it more attractive for the banks to deal with the Central Bank thus strengthening the country's external reserves position.

An analysis of the credit situation during late 1980 revealed a sustained expansion in private sector credit which was a cause for grave concern having regard to the fact that the pressure on the balance of payments at that time of the year is usually acute. In view of this, on November 28, the Bank imposed a surcharge of 2 percentage points on loans granted to commercial banks. The intention was to discourage frequent recourse by banks to Central Bank borrowing and to encourage them to be more selective in their allocation of credit.

The Central Bank main objective has been and will continue to be the protection of the country's international reserves. Recognizing the difficulties involved in attempting to control the demand for foreign exchange in an open, dependent economy like The Bahamas, the authorities have taken measures aimed at increasing the supply of foreign exchange. It is hoped that these measures will achieve the desired results, namely, that of maintaining a strong foreign reserves position thus allowing the country to comfortably finance the import of goods and services that are so vital to its continued growth and development.

FOOTNOTES

(1) Authorized dealer is defined as a bank which has been authorized by the Exchange Control Department to deal in gold and all foreign currencies, and for this purpose they can open and maintain accounts in such currencies, within the limits laid down from time to time in the Exchange Control Notices issued by The Central Bank of The Bahamas. They can also approve certain applications under delegated authority. Authorized agent is defined as a bank or trust company authorized by the Exchange Control Department to deal in Bahamian and foreign currency securities and to receive securities into deposits (to act as custodians) in accordance with the terms of the Exchange Control Regulations 1956 and The Exchange Control Notices issued, from time to time, by The Central Bank of The Bahamas.

(2) The monetary base is defined as the supply of notes and coins in active circulation (i.e., with the non-bank public) and banks' reserves at the Central Bank.

(3) A non-resident bank and/or trust company is one which can operate only in foreign currencies, but may hold a Bahamian dollar account, with Exchange Control approval, to pay local expenses.

(4) A resident bank or trust company is one that can deal only in Bahamian dollars, but can operate in foreign currencies with the authorization of Exchange Control. Trust companies with resident status are allowed to deal in foreign currency securities on behalf of non-resident customers.

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