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THE BAHAMAS ECONOMY

Where Things Stand and Where We Are Likely Heading

DECEMBER 21, 2020

Like all economies across the world, The Bahamas is facing significant challenges posed by the pandemic. But apart from this important setback, The Bahamas was grappling even before the pandemic hit, with some pre-existing conditions that significantly weakened its ability to respond as the authorities may have liked to.

Hurricane Dorian hit The Bahamas at category 5 in September 2019, and to date, is the most destructive hurricane and worst natural disaster to have ever hit The Bahamas, causing about USD3.4 billion or 25% of GDP in damage.

Within 6 months of this unprecedented disaster in The Bahamas, the pandemic hit, and the tourism industry -

- On which The Bahamas has one of the highest levels of dependence in the Caribbean, and is #3 globally, after Aruba and Antigua and Barbuda;

- Which is the largest driver of jobs;

- Which contributes nearly 50% of GDP;

- Which is dependent on the USA for 80% of all stopover arrivals;

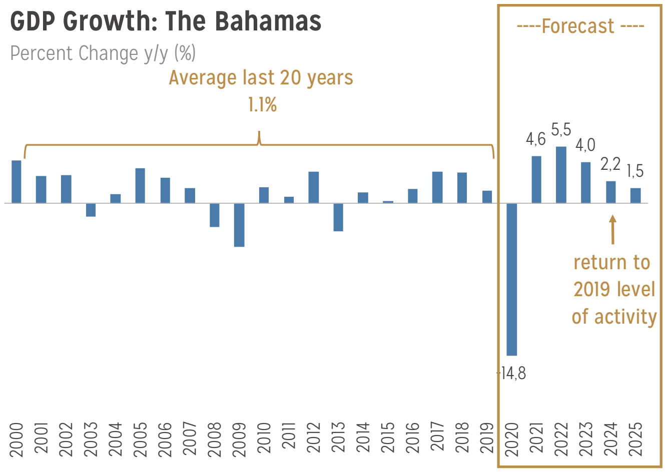
- Which is dependent on cruise passengers for over 75% of tourism arrivals;

- Which is responsible for about 40% of fiscal revenue;

- Which is responsible for over 75% of export earnings...

came to a sudden stop. Never before has the global economy come to a sudden-stop. Never before has the tourism industry in The Bahamas ever come to a sudden-stop.

And never before has any country in the Caribbean (and maybe even globally - but please don't quote me) had to grapple with the worst natural disaster in its history AND (arguably) the worst economic crisis in its history, BOTH within a six-month timeframe. How the Government of The Bahamas has maintained a reasonable level of socio-economic stability so far, is testament to their capabilities, political will, and ability to access assistance from external parties including the multilateral lending institutions. By no means could this be an easy task, and the Government is certainly dealing with a lot more than many, at least in a regional context.

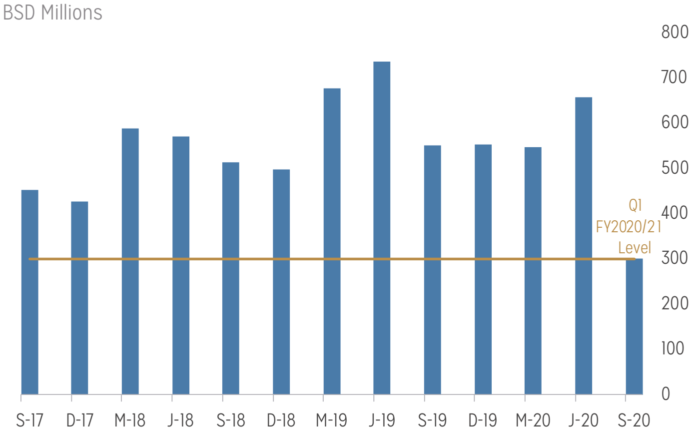


Source: IMF, Marla Dukharan

Growth in The Bahamas for the past 20 years has averaged only 1.1%, which indicates that the economy had been quite stable, but somewhat stagnant. The economy is expected to contract by close to 15% this year, and GDP is not expected to return to the 2019 (pre-crisis) level until 2024. This tells us a few things: it tells us that unemployment will likely remain high, the private sector (especially tourism-dependent, state-dependent, and domestic consumption-dependent) will likely experience lower levels of revenue / activity, and therefore, within the existing taxation frameworks, the Government of The Bahamas will likely see its fiscal revenue trend continue to be severely constrained.

Government Revenues, Quarterly: The Bahamas

BSD Millions

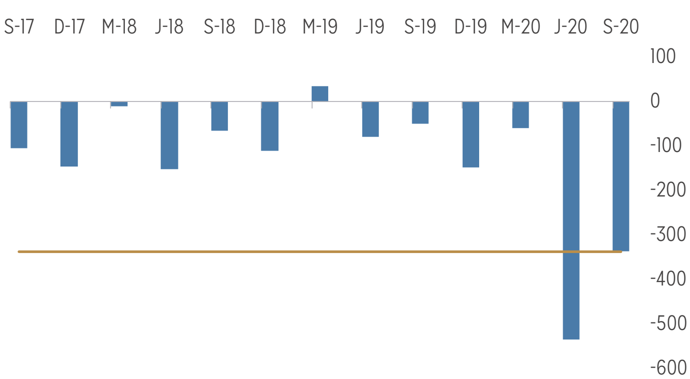


Source: Central Bank of The Bahamas, Marla Dukharan

And given that the Government is facing lower levels of flexibility as it relates to expenditure, not just from the usual sources such as debt servicing and other non-discretionary obligations, but now also from pandemic-related spending demands including social spending - the fiscal deficit is expected to reach its highest level ever at about BSD1.3 billion or 12.4% of GDP in the current fiscal year according to Standard and Poor's - all of which the Government will have to borrow in a very short timeframe.

Fiscal Deficit, Quarterly: The Bahamas

BSD Millions

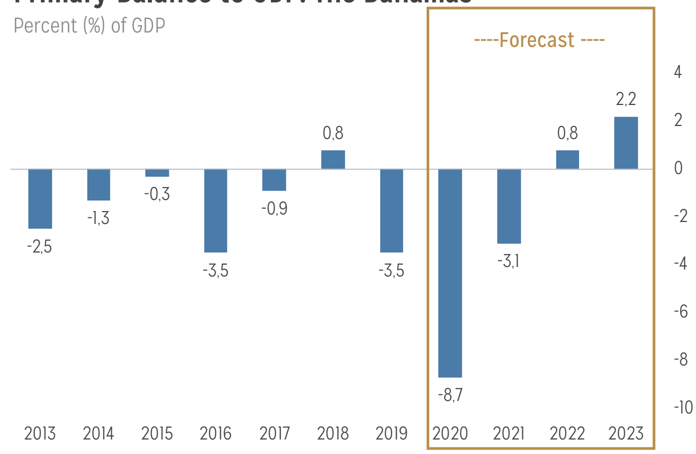


Source: Central Bank of The Bahamas, Marla Dukharan

It is important to note that even before Hurricane Dorian in 2019, The Bahamas' primary fiscal balance was consistently in deficit for some time (which means that the Government is already in deficit before it pays the interest on its existing debt, so it has to BORROW to pay the INTEREST on existing debt), suggesting that there is a structural problem with the Government's fiscal affairs, as opposed to an exceptional or event-driven problem. A longstanding primary fiscal deficit - and borrowing to pay interest on existing debt - is a good indication that the level of debt is already unsustainable, regardless of what your debt/GDP ratio looks like.

Primary Balance to GDP: The Bahamas

Percent (%) of GDP

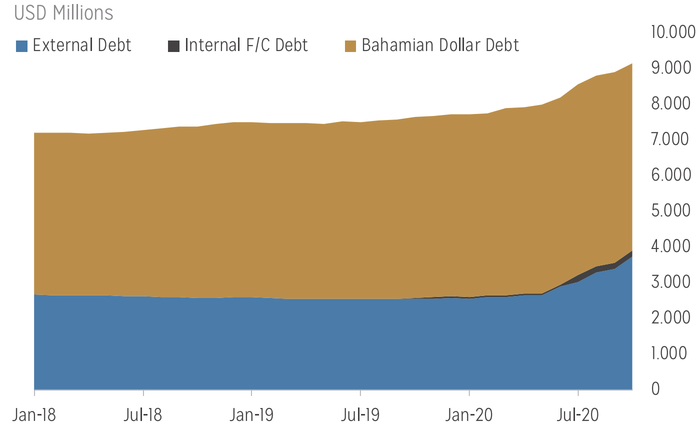


Source: S&P Rating Action, November 12, 2020, Marla Dukharan

On the issue of debt/GDP, important empirical evidence exists to suggest that in the Caribbean, beyond a level of about 56% debt/GDP, each additional dollar of debt has a negative effect on the size of the economy. This means that over roughly 56% of GDP on average, each dollar of additional debt will shrink the economy. Moody's reported that The Bahamas' Debt/GDP was already 60% in 2019, indicating that the country was already carrying an unsustainable debt level even before these crises hit. Standard and Poor's estimates that the Government will have to borrow a further BSD1.3 billion in this fiscal year, and over BSD800 million in FY2021/22. This will drive The Bahamas' fiscal and debt trajectory further into unsustainable territory, increasing the likelihood that the Government will run into difficulty to service its debt payments.

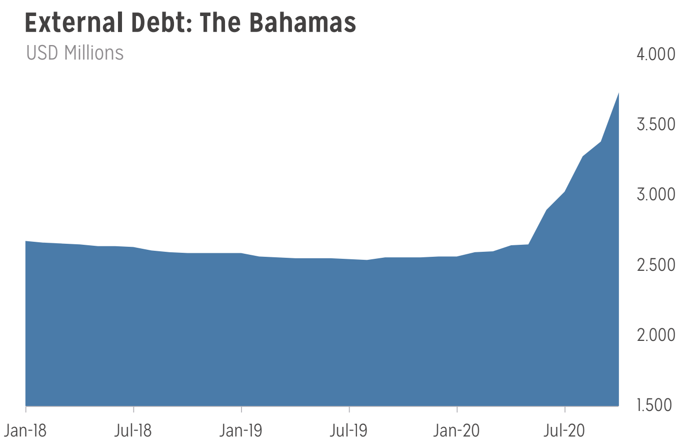
Direct Debt: The Bahamas

USD Millions



Source: Central Bank of The Bahamas, Marla Dukharan

What is particularly worrying about the rising level of debt in The Bahamas, is the fact that the Government is relying more and more heavily on borrowing in USD (external debt). The reason for this is that the Government needs to ensure that it has sufficient reserves of foreign exchange to defend the exchange rate and to cover the nation's foreign currency obligations. The loss of foreign currency inflows via tourism puts additional pressure on the Government to compensate for this via raising debt in USD.



Source: Central Bank of The Bahamas, Marla Dukharan

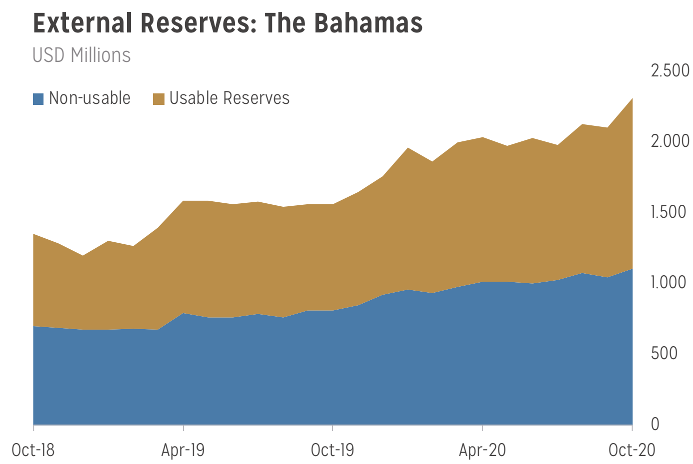
Debt on the whole raises two very important challenges - (1) having the funds to repay it (and not just at maturity, but the periodic interest/coupon payments) in the relevant currency, and (2) the fact that borrowing finances fiscal spending, which drives higher outflows of USD reserves via fiscal leakage. Let's deal with each of these in turn.

Borrowing increasingly in foreign currency implies that there are more and more foreign currency obligations to fulfil, just when the nation's foreign currency earnings are probably at their weakest. This means on a net basis over time, based on foreign currency debt alone and the repayment thereof, there is a higher net outflow of USD - unless this foreign currency borrowing is being used to finance some investment that earns more foreign currency than it costs.

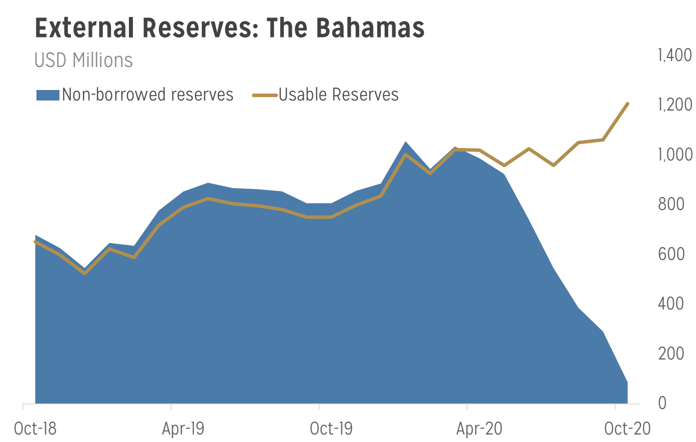
It is important to note that it is not just at maturity that the risk of default presents itself. Indeed, the two most recent debt default/restructure scenarios that took place in the Caribbean - Barbados in 2018 and Suriname in 2020 - were not triggered by a sovereign bond maturity.

Furthermore, the wider the fiscal deficit (especially if financed by borrowing in USD), the higher the extent of fiscal leakage (where Government spending drives imports), and therefore, the greater the pressure on the level of foreign exchange reserves held by the Central Bank.

Interestingly, usable reserves increased by only USD456.36 million y/y in October 2020 to USD1.207 billion, while at the same time external debt rose by USD1.177 billion to USD3.737 billion.



Source: Central Bank of The Bahamas, Marla Dukharan



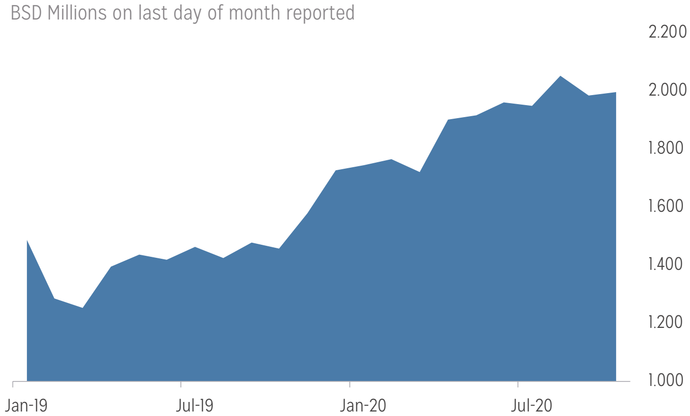
Source: Central Bank of The Bahamas, Marla Dukharan

Domestic debt, or debt denominated in local currency, is much less problematic, except when the Government is in effect bankrupt and does not have the liquidity to repay maturing local debt, and is having difficulty rolling-over matured debt or issuing new debt. Governments facing such liquidity challenges have been known (within the region and beyond) to resort to 'printing' local currency to honour its obligations. We saw this in Barbados leading up to their 2018 default/restructure, and we saw this in Suriname most recently. Venezuela and Zimbabwe are contemporary poster-children for this type of policy. One of the most common results of such an approach, is the inflationary pressures that the expansion of the money supply causes. In addition, as the amount of local currency in circulation increases, it also puts pressure on the currency, because it stokes consumption, which is largely satisfied by imports, causing a greater outflow of foreign currency. As a consequence, there are lower and lower levels of foreign currency reserves held at the central bank, to defend the exchange rate.

We have seen some expansion in the monetary base, particularly since early 2019. Currently the monetary base stands at roughly the same level as foreign currency reserves held at the Central Bank - meaning that there is roughly a 1:1 ratio between the monetary base and external reserves. This suggests that the exchange rate is defensible at a 1:1 ratio. However, the monetary base is over two times the level of non-borrowed foreign currency reserves held at the Central Bank. This means that the exchange rate is being defended partially via borrowing, which is not a sustainable policy approach.

Monetary Base: The Bahamas

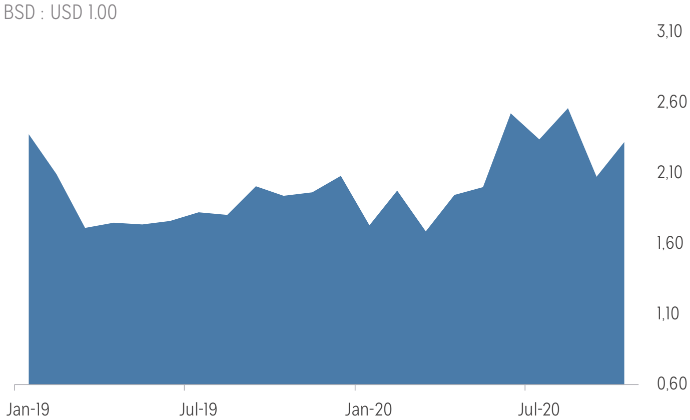
BSD Millions on last day of month reported



Source: Central Bank of The Bahamas, Marla Dukharan

Monetary Base / Non-Borrowed Reserves: The Bahamas

BSD : USD 1.00



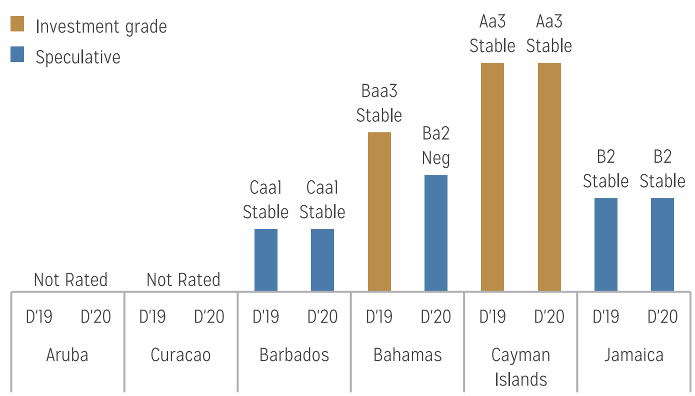
Source: Central Bank of The Bahamas, Marla Dukharan

HOW HAVE THE RATINGS AGENCIES RESPONDED TO EVENTS IN THE BAHAMAS?

The exceptional circumstances that have affected The Bahamas over the past 15 months or so, are borne out in the downgrades the Government of The Bahamas has suffered as a result. Notice that Moody's and S&P both downgraded The Bahamas this year, with the Moody's downgrade taking it into non-investment grade / speculative grade / junk territory, where S&P has had The Bahamas since December 2016. Moody's has not downgraded any other tourism-dependent country in the Caribbean this year apart from Belize, while S&P downgraded The Bahamas and Curaçao this year. Fitch downgraded Aruba this year, but does not rate The Bahamas. These jurisdictions are possibly the most acutely affected by the pandemic-driven sudden-stop, based on their high socio-economic dependence on tourism - specifically US tourists in the case of The Bahamas and Aruba - and the negative spillovers from Venezuela's collapse, in the case of the Dutch territories.

Moody's Credit Rating: Tourism-dependent Economies

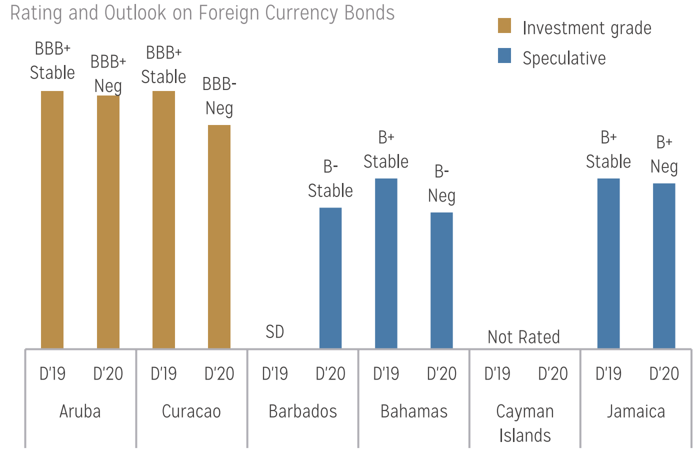
Rating and Outlook on Foreign Currency Bonds



Source: Moody's, Marla Dukharan

S&P Credit Rating: Tourism-dependent Economies

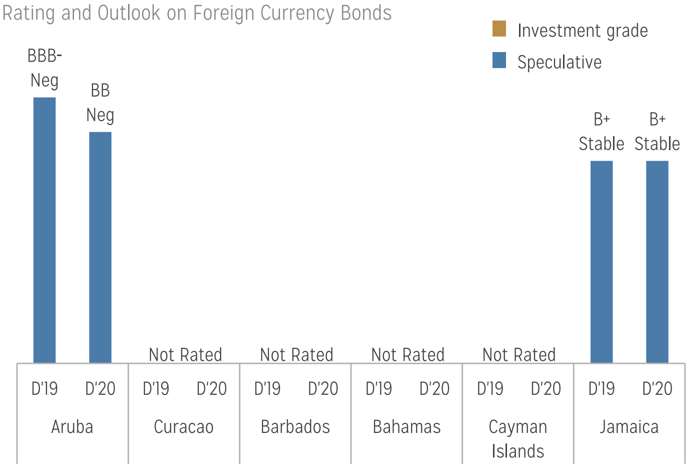
Rating and Outlook on Foreign Currency Bonds



Source: S&P Global Ratings, Marla Dukharan

Fitch Credit Rating: Tourism-dependent Economies

Rating and Outlook on Foreign Currency Bonds



Source: Fitch Ratings, Marla Dukharan

According to Moody's, "The credit profile of The Bahamas (issuer rating Ba2) is supported by the country's 'ba2' economic strength, reflecting the Bahamian economy's small size, subdued growth outlook dependent on tourism, high income levels and exposure to climate event risk; The Bahamas' 'baa2' institutions and governance strength, reflecting strong institutional quality and an improving set of rules to guide still-developing fiscal policy as the main tool for policymakers in the context of the currency peg; its 'caa1' fiscal strength, taking account of the government's high and rising debt burden and low debt affordability; and its 'baa' susceptibility to event risk, reflecting government liquidity risks associated with higher funding needs and constrained market conditions."

On Nov 12th 2020, S&P lowered their long-term foreign and local currency sovereign credit ratings on The Bahamas to 'BB-' from 'BB', which carries a negative outlook, reflecting a one in three chance the rating could be lowered over the next year if the economic recovery in 2021 is weaker or more prolonged than expected. S&P stated "The country's fiscal reform measures have evolved slowly, and we expect the pandemic will hinder meaningful public finance reform, while large fiscal deficits and a high debt burden increase funding pressures. We have lowered our institutional assessment of The Bahamas due to the political challenge of addressing shortcomings in public finances in an uncertain economic climate over the next one-two years. Based on the gross external liabilities of the country's large banking sector, we expect the gross external financial needs of the public and financial sectors will be 352% of current account receipts in 2020, up from about 200% in 2019. S&P now expects the economy to show a contraction of 21% in 2020 with a gradual recovery starting in 2021, although it will take several years to reach pre-pandemic levels of activity."

CONCLUSION

All of the above suggest that The Bahamas is facing a potential Balance of Payments crisis, which is possible in the next year or two - not because the Government has not managed these crises appropriately, but because it is hard to imagine how any small, open, developing economy would be able to successfully survive its worst natural disaster in history, and a global sudden-stop, within one year. A balance of payments crisis would not necessarily reflect on the authorities as much as it reflects The Bahamas' vulnerability, and indeed, that of many in the Caribbean. A balance of payments crisis would not necessarily reflect on the authorities as much as it reflects The Bahamas' vulnerability, and indeed, that of every country in the Caribbean. In order to create the sustainable long-term progress we desire, we must reverse our poor policy choices, such as fiscal imprudence, which have contributed to our 'pre-existing conditions'. This pandemic, like every crisis, presents us with a precious opportunity to take a long, hard look at our current policy approach and fearlessly adopt a transformative path towards the future we deserve.

CHART

In Million of Dollars	BSD/USD millions @OCT	% y/y @OCT 2020	Var $ y/y @OCT 2020
External Debt	3737	46.0%	1176.8
Internal F/C Debt	180.4	1102.7%	165.4
Bahamian Dollar Debt	5241.7	3.5%	178.2
Total Direct Debt	9159.1	19.9%	1520.4
Total Amortization	443.9	156.4%	270.8
Total Public Sector F/C Debt	4503.2	5.1%	216.6
Other Public Sector F/C Debt (non CG)	766.2	-55.6%	-960.2
External Reserves	2314.11	48.2%	752.32
Usable Reserves	1207.70	60.7%	456.36