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THE MONETARY and FINANCIAL SYSTEM OF THE BAHAMAS

Growth, Structure and Operation

by Ramesh F. Ramsaran

THE AUTHOR

Ramesh Ramsaran, a Trinidadian, received his tertiary education at the University of the West Indies (U.W.I.), graduating with degrees of B.Sc. (Econ.), M.Sc. (Econ.), Ph.D. (Econ.) respectively.

Between 1968 and 1970 he worked as a Research Asssistant with the Institute of Social and Economic Research, U.W.I., on the 'Foreign Investment Programme', and from 1970 to 1973 he was employed as a Junior Research Fellow at the Institute of International Relations (IIR), U.W.I., Trinidad. During his three-year period with the IIR, his work focussed mainly on Commonwealth Caribbean-Latin American Relations.

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THE MONETARY AND FINANCIAL SYSTEM OF THE BAHAMAS: GROWTH, STRUCTURE AND OPERATION

The Bahamas has attained an international reputation as a tax haven and as a tourist resort. Over the years, tax haven policies have encouraged the proliferation of a wide range of financial institutions and activities which have helped to sustain economic life in the country. While, however, finance tends to be promoted as an activity in itself, the issues relating to the role of monetary and financial arrangements in general economic development are, by no means, absent or irrevelant. The Bahamas is a developing country, and like other developing countries, it aspires to attain a more diversified economy capable of of generating production, income and employment on the required scale.

This study examines the nature of the monetary and financial structure which has emerged in the Bahamas, and attempts to put the 'onshore' and 'offshore' aspects in a perspective which highlights the problems and issues of policy-making in a development context where tax haven status is also official policy.

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To the memory of my parents
and
To a new generation of Bahamians

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PREFACE

The growing number of studies, both at the theoretical and empirical levels, on the role of finance and financial institutions and policies in the process of economic development, reflects the increasing importance which this topic has come to assume in discussions relating to economic and social advancement. The attempt to focus on a particular aspect of a more general problem, it should be pointed out, however, does not deny the need for attention in other related areas. The problem of development calls for action over a very wide front. The success of measures in one sector tends to depend on policies being pursued in other areas of the economy.

The rationale for a study of one aspect of the rather complex problem of development in a particular situation lies in the fact that this approach not only permits a fuller expression of views, but it oftens helps in identifying critical points for complementary action. This is particularly so where little work (of either a specific or general nature) has been done, or where the national perspective, as it relates to strategy options, has been significantly distorted by an erratic historical experience.

In undertaking this study of the monetary and financial system of the Bahamas, the aim was two-fold. Firstly, it was hoped that the exercise would not only provide some insights into this particular system, but would lay the groundwork for more comprehensive and in-depth studies as a wider range of data becomes available, and as existing time series assume larger dimensions. Secondly, it was hoped that the findings (however tentative) would provide some guidelines for policy formulation in certain critical areas. These objectives have been affected by certain conditions which were anticipated, and which need to be indicated. To begin with, the Bahamas does not have a statistical tradition. The collection of statistics on a systematic basis is a relatively recent development in this country. Most series do not go beyond the late '60s. The range of data collected, too, is inhibited by the tax haven status of the country. While the Government provides guarantees against certain types of disclosures, private enterprises have, in some cases, extended this undertaking to cover information needed by the administrators for policy making and planning purposes. Gradually, however, private operators are becoming aware of the need to furnish certain statistics to Government departments. The persistence of certain international organisations to which the Bahamas has acceded since independence has, no doubt, had an effect on this trend. Some of the information used, it should be noted, is extremely tentative. With respect to the presentation of data, an important comment needs to be made. There are instances, it would be noticed, where some of the statistics used seem a bit outdated. This may be the result of both the unavailability of more up-to-date figures and a perception that the picture depicted has not changed materially, with time. One of the effects of this data situation on the study has been the inability to develop certain points in areas where a more extended and critical analysis was called for, particularly with respect to the behavioural aspects of a number of institutions.

Over the last two decades the Bahamas has attracted a great deal of attention as a tourist resort cum tax haven. Apart from a few historical works of a general nature, a great deal of what has been published on this country has revolved around promotional objectives relating to these two activities. Serious and in depth analysis of existing policies or the prospects for development is difficult to find. For this reason the attempt has been made here to provide as much information as possible, even while recognising the partial nature of the exercise. This situation also explains to some extent why a somewhat comprehensive approach to the study was decided on, rather than one focusing on a narrow area involving a particular set of institutions and relationships or a limited theme.

In addition to a brief introductory section, which discusses the development role of finance and financial institutions in the theoretical literature, and a concluding chapter, which summarises the main points of the study, the work is divided into seven main chapters.

Chapter 1 attempts to provide as much information as possible on the economy and the society. This is necessary if one is to put the monetary and financial sectors in their proper perspective. The various real components are discussed in terms of the overall structure and the inherent problems being faced. Government's policies and strategy are also critically examined.

Chapter 2 is devoted to the commercial banking system. Here is seen not only the historical growth of the sector and its present structure, but also its role in the savings process, the monetary system and in development financing activities. Commercial banks occupy an important position in the financial system and their operations have far-reaching economic and social implications.

Chapter 3 is concerned with an analysis of the insurance industry in the Bahamas. The chapter is divided into two sections. One section examines the operations of companies doing domestic business while the other discusses the 'offshore' or 'captive' companies whose operations are entirely external. Though this latter group is not involved in the economy (whatever benefits they bring tend to be of an indirect nature), a discussion on them has been included in the light of the Government's effort to promote the Bahamas as a centre for captive companies. The section dealing with the local insurance business centres largely around the significance of insurance in the economy. Its role as a savings medium and as a source of investment funds is critically examined.

Chapter 4 covers a number of institutions. These include the finance companies, the Post Office Savings Bank, the People's Penny Savings Bank, the Trust Companies and the Bahamas Development Bank. The main focus here is on the nature of the business conducted by these entities as reflected in their balance sheet positions and/or as dictated by their respective constitutions. Where necessary, an attempt has been made to assess the prospects facing particular institutions in the present-day environment.

In Chapter 5 the factors which have contributed to the emergence of Nassau as a Euro-currency centre are examined, as also the effects of Euro-currency operations on the domestic financial system.

Chapter 6 discusses currency arrangements and the scope for monetary policy in the Bahamas. It has been necessary to include a description of monetary institutions preceding the Central Bank in order to better appreciate the latter's role and functions in a setting requiring greater governmental intervention in the economy.

In Chapter 7 the status of the Bahamas as a tax haven is examined and the implications of this status for Government's financial position and for public policy, generally, in both a short and long term context is analysed. The inclusion of this chapter stems from the conviction that it is not only necessary to have an insight into the public finance situation in order to provide a wider perspective of the financial sector, but from the fact that the policy regarding tax havens has tended to influence approaches in respect of the role of the domestic financial system.

ACKNOWLEDGEMENTS

The research for this study was largely conducted while I was attached to the Institute of Social and Economic Research as a full-time member of the Regional Programme of Monetary Studies. For a period, it was necessary for me to be resident in the Bahamas and I am deeply indebted to the Central Bank of the Bahamas for its cooperation and the facilities put at my disposal.

At an individual level it is impossible to name everyone who has provided help to me in one form or another. Mr. Alister McIntyre took a personal interest in the study and his encouragement and guidance in times of difficulty were invaluable to the completion of this work. I owe a great debt to Professor Clive Thomas for a detailed critique of a first draft of the study. The suggestions and criticisms of Dr. Compton Bourne also went a long way to improving my initial effort.

In the Bahamas, the kindness of the staff of the Central Bank must be acknowledged. Several members were also extremely helpful in clarifying issues and setting up appointments with people in the private sector. In this respect, Mr. William Allen (now Governor), Mr. Frank Davis (the Inspector of Banks) and Mr. Warren Rolle (the former Secretary, now with the Bahamas Development Bank) were particularly helpful. Mr. Bert Sherman and Mrs. Pat Bethel provided invaluable assistance in a number of areas. Without the cooperation of the former Registrar of Insurance Companies, Mr. Charles Donaldson and the present incumbent, Mrs. Octavia Johnson, the section of the study dealing with the insurance companies would have been far less detailed. To the many other people, both in the private and public sectors, who offered advice or shared their experience in what was an acknowledgedly difficult undertaking, I can only make a general expression of gratitude.

It is difficult to be engaged in the study of economic and social development in this part of the world and not benefit from the work done by some of my more senior colleagues in this field. The financial studies (published and unpublished) done in recent years have been particularly helpful to me.

Finally, let me add that the views expressed in this study are not to be taken as a reflection of those of any of the institutions or persons named above. I also take the responsibility for any shortcomings that remain.

SYMBOLS AND ABBREVIATIONS USED

n.a. or na	not available
– or . .	nil or negligible
CBB	Central Bank of the Bahamas
Co. or Cos.	Company or Companies
B$	Bahamian dollar
BMA	Bahamas Monetary Authority
m	million
US$ 1	= B$ 1

All figures are in Bahamian dollars except where otherwise stated.

Note: Percentage breakdowns may not exactly add to 100 because of rounding.

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INTRODUCTION

Though there is no clearly defined relationship between the growth of the financial system and economic development, generally - and here we are speaking mainly in the context of a market economy - one finds a parallell expansion taking place between the real and financial sectors, with the latter often responding to and reflecting developments taking place in the former in the process of growth. It follows naturally from this that the pace at which the financial system expands (in terms of the number and range of institutions, the variety of services and the growth in assets) would tend to be significantly determined by the pace of real economic growth. This, generally, would be the nature of the relationship where the dynamic is exclusively internal or largely so, even though the institutional super-structure might be linked to an international system making possible the operation of an exogenous factor.[1] In the environment of a financial haven, however, where a substantial portion of the business of the financial sector is generated from outside, the structure and pattern of the financial system will tend to reflect the needs of an external clientèle, and in such circumstances the system can expand without any counterpart growth in the real sector of the domestic economy. A further and more fundamental consequence of this type of situation from the viewpoint of the local community, is that although the larger realm from which the financial institutions draw their business should enable them to play a more dynamic role locally, the fact that only a small part of their income may be derived from local sources can lead them to be very indifferent to the needs and problems of the economy and society, particularly if these institutions are foreign owned and controlled with no natural commitment to the country of domicile. In a financial haven, therefore, the growth in total financial assets and in the range of financial institutions and services can be a very misleading index of real development or of the state of the economy, and in this connection it should be noted that the term 'financial centre' which is often used in reference to some countries which act as little more than conduits through which foreign transactions pass, does not necessarily reflect the capital position of these countries as it relates to domestic activities, either in a total or qualitative sense.[2]

In this connection there is another point which needs to be noted. While there are certainly some benefits to be derived by countries that operate tax havens, these benefits have to be seen in a total context if the formulation and implementation of overall economic policies are to be carried out in a manner consistent with the structure and functioning of the economic system. In other words, in a situation where the major part of the income and employment is generated by domestic activities, the pursuit of tax haven objectives without a clearly defined set of policies can easily lead to a compromising of the domestic role of financial institutions under very mistaken notions of what is required to attain particular goals, with serious consequences for long term growth and development. In a boom period, this aspect of policy may not appear to be particularly important, for obvious reasons. It is only when a downturn in activities begins to manifest itself in the social and economic conditions of the country that the governmental authorities may become alive to the need for direction in the use of domestic resources, among other measures, and the role of financial institutions in the development process – an awareness that can easily lapse again in a period of prosperity. It is well known that basic structural problems in an economy are not necessarily resolved as a result of a high level of activity confined to one sector and based on the possession of some mineral resource, or a vibrant export crop. The same is no less true of countries like the Bahamas which have benefited from the tourist boom and a fortuitous set of circumstances in the post-war period. While certain commonly used indices of economic well-being can be favourably affected under such conditions, these measures tend to mask a serious state of underdevelopment for which deliberate action is required over a very broad front.

As will be seen shortly, while the Bahamas' economy has a peculiar set of features, the problems facing it resemble, in fundamental ways, those facing other poor countries both in the Caribbean and elsewhere. In the approach of these problems, however, there is, in the case of the Bahamas, an extra dimension which arises out of the desire by the Government to promote the country as a tax haven and as a centre for 'offshore' financial activites – a desire which, as we said, if not properly articulated could, by the policies required to give effect to it, seriously interfere with the efforts required to deal with questions that have a critical bearing on the course of development and on the welfare of the mass of Bahamian people. The main focus of the study is on the nature and pattern of the monetary and financial system which has emerged in the Bahamas in response to certain internal and external developments in the post-war period, and its behaviour and performance in the context of the national effort being made to redress existing social and economic ills.

The Financial Sector and Economic Development: The Theoretical Basis

In the study of economic phenomena the so-called classical economists paid little or no attention to financial intermediation as a factor in the growth of real wealth. The main reason for this is to be found in the basic (often implicit) assumption that investment was largely financed from internal savings (retained earnings). While self-financing can be quite important (and indeed accounts for a large part of capital formation in some countries), it is clear that a country dependent solely on this source of funds would find itself severely constrained in exploiting its potential.

One of the advantages of a monetary economy is that it not only permits saving to take a financial form,[3] but also facilitates the transmission of such resources from one economic unit to another, thus making possible a certain amount of flexibility in income and expenditure patterns. Of course, the transmission mechanism itself is important, and this often emerges both as an outgrowth of a response to increasing monetisation and development.

Recognising the importance of financial intermediation, neo-classical growth theorists have given it a central role in their discussions of real asset formation. In these models, however, financial intermediaries are generally assumed to be functioning in a competitive situation which permits them exclusive discretion in the disposition of resources. Optimality in the distribution of investible funds is taken for granted. While the real world conditions may differ considerably from the idealised conditions assumed by neo-classical theoreticians, the link between the financial superstructure and real growth seems to be well founded. The relationship, however, as we indicated earlier, is by no means a simple one. Some interesting theoretical and empirical work[4] has been done on this subject, providing not only a basis for informed speculation, but having a direct influence on financial thought and policies in many developing countries. One writer sums up the mood of the day when he says that financial development may well be "a pre-requisite, if not a major determinant, of the take-off into self-sustained economic growth".[5]

Whatever the nature of the relationship between financial development the real growth, the post-war literature on the problems faced by poor countries pays increasingly greater attention to the role of finance and financial policies in the process of development.[6] In this respect, special emphasis tends to be placed on the function of savings in the economy. In fact some writers see domestic savings as one of the central issues in development, perceiving a direct correlation between the level of savings taking place and economic growth.[7] The expansion of productive capacity, income and employment is made to rest heavily on the availability of financial resources. In this respect external funds can play a part, but unless an increasing proportion of the income generated is saved and invested, self-sustaining growth will not easily be achieved. Besides, dependence on foreign capital has its own drawbacks which we shall refer to a little later.

Seen from this perspective, financial development refers to the whole spectrum of changes in terms of financial institutions, instruments, activities and relationships which could lead to a higher and more efficient level of savings and investment in an economy. At the centre of the process is the role of financial intermediation which consists essentially of collecting savings (and other funds) and making these available to borrowers for spending purposes. In any monetary economy this is an important function. In a development context, however, it takes on particular significance. Expenditure, as is well known, can be divided into two broad categories, viz., consumption spending and investment. While the former is inevitable and must rise over time with the standard of living, it is the latter which is of crucial importance from a development standpoint, since it is the basis of real asset formation and a critical determinant of the rate of growth. The higher the level of savings in an economy, the larger the volume of investment that is possible. An important point to note here, however, is that the people who save are not necessarily the same people who invest. At any point in time there will be units which will not permit their expenditure to exceed their income. Part of this expenditure may be of an investment nature, based on internal savings. There will also be individuals and institutions who spend more than they earn (net spenders or borrowers). Similarly there will be units whose income exceeds their expenditure (net savers). Among the former group there will be some savers in the same way as there will be some investors in the latter. Direct dealing between the net spenders and net savers does take place to some extent in any economy through the issue and acceptance of 'direct debts'. A major limiting factor in this respect, however, arises from the conflicting needs of units with loanable funds and units seeking capital for investment purposes. In such a situation financial intermediaries (and there is a great variety of them) play a critical role in pooling resources (and risks) through the offer of financial assets ('indirect debts') to ultimate lenders and then relending these to ultimate borrowers (through the acquisition of 'primary debts'). In this way financial institutions not only encourage a higher level of savings through the offer of suitable assets, but also make possible investments which might not otherwise be undertaken.[8]

In an open economy, the function of intermediaries in providing financial investment opportunities takes on added significance since, in the absence of these, the alternative may not just be increased domestic consumption, but a larger volume of imports financed by valuable foreign exchange reserves. In an economy producing its own consumer goods using domestic inputs, increased consumer spending is likely to have a stimulating effect by providing an incentive to greater production and income via the multiplier process. In a small economy depending on foreign sources for the bulk of its requirements, however, such a multiplier effect is felt abroad. The outflow, of course, can also be direct in the form of investment in foreign money market instruments by financial intermediaries themselves, when they are permitted to do so.

The functions of financial intermediaries, therefore, clearly have implications for development. It has to be pointed out, however, that these entities are not inherently developmental institutions as such. Their primary motive is to make a profit, and this is a major factor influencing their behaviour. Their lending patterns, of course, are not without constraints. One of the most important of these is the nature of their liabilities. Another is the regulatory framework within which they are made to operate, whether this relates to safety or to economic considerations. With respect to the former constraint, the term conditions under which funds from the public are accepted will have a critical influence on the broad pattern of lending undertaken. The pooling of individual risks, however, and the ability to predict (based on experience) the inflow and outflow of resources, gives financial institutions some degree of flexibility in transmuting financial liabilities into financial assets. As far as the latter constraint is concerned, financial intermediaries (which have largely been foreign-owned and controlled) in developing countries have until recent years been subject to minimal regulations in the disposition of their funds. The close relationship between national money markets and metropolitan centres often serves to encourage the outflow of resources from developing areas, even when there is an urgent need for such funds to be deployed in the country of origin.

In recent years there have been developments on two fronts affecting the operations of financial institutions in developing countries, which, however, still continue (for the most part) to be dominated by international concerns based in the developed countries. At the international level the changes in the financial system have increased the risk of moving from one currency to another and back again. At the domestic level economic and social pressures have forced many governments to institute programmes not only designed to retain domestic resources at home, but to influence the patterns of their disposition. Among measures taken are the encouragement of indigenous entities to compete with the foreign concerns, the legislation of select credit control powers and tightening of the administrative framework, particularly exchange control regulations. Despite all this, the financial sector generally has been slow in changing its perspectives and reconciling its functions to national objectives as seen in a development context. The reaction to this, of course, has been an intensification of the pressures of nationalisation or localisation with the hope that such a policy would make these institutions more sensitive to local conditions and aspirations.

It is important to point out here that a financial system can follow one of several models, depending on the particular economic and political context. At one end of the spectrum the system can be permitted to play essentially what can be termed a neutral (or nonchalant) role with respect to development. In such a case its function consists largely of collecting savings and disposing of them as it sees fit from its own internal objectives and on the basis of its own criteria. At the other end lies the model which imparts to the financial system an explicit role, politically defined and directed to achieving clearly stated goals. In the former case, the level of savings may bear no relationship to capital formation since lending may be concentrated in non-productive areas which yield high returns to the lenders but do not assist long term development. It is this model which has for long prevailed in many developing countries, and which is only now being modified in many cases to conform to national requirements. The failure of a financial system to play an active role with respect to the mobilisation of resources or to concentrate its lending activities in areas that are important to the long term growth of the economy has direct as well as indirect consequences for the development process. One of the indirect consequences is that it creates a condition which could lead to increasing reliance on foreign savings, which in turn requires a policy framework that may conflict with long term developmental objectives. There may be some instances where a state may deem it necessary to have foreign capital because of the volume of funds or the technology required to initiate a particular project or enterprise. In many cases, however, there is no carefully thought-out policy with respect to foreign capital and the kind of investment encouraged serves not only to stunt the growth of local enterprise, but perpetuates a dependence on foreign sources for funds, since profits tend not to be retained in the national economy but to flow out of the country. Even if income accruing to foreign enterprises were to be reinvested one of the consequences of this policy would be that a larger and larger share of the domestic economy would come under foreign control in the absence of clear guidelines to increase local ownership.

It would appear from the above discussion that the development of the financial sector is not an end in itself, but a necessary part of, if not a pre-requisite to, the whole process of real development. Of course, it does contribute to income and employment, but this is not where the significance of the sector generally lies. There may be situations where the latter aspect takes on more than normal importance, but the intermediary role of financial institutions remains important within the framework of the overall economy and the effort being made to develop. In such circumstances it is this latter function that has to be stressed and developed. In the process of financial development, government policies are important. So too, however, is the role of financial institutions which must seek to experiment and innovate with a view to increasing the efficiency of the savings/investment process. In this respect, the orientation and perceptions of the financial sector are fundamentally important. In cases where the growth and development of the domestic economy are viewed as being of significant importance to its overall operations and long term profits position, the perspective is likely to be different from that in a situation where the opposite is the case. The smaller the volume of local business in relation to the total transactions conducted by resident units, not only may they feel less compelled to help improve domestic conditions, but also more inclined to resist governmental direction and ignore national objectives if these are not considered to be in their own interest. Where, of course, financial institutions are part of international concerns operating in a large number of countries, these tendencies become even more likely.

In such circumstances government's policy will tend to be influenced by the respective weights placed on the values attached to the importance of the financial sector to domestic development, the 'incidental' benefits being derived from the existing pattern and organisation of the financial structure and the advantages associated with the sector's participation in non-domestic activites. These different considerations need not be mutually exclusive, or react on each other in a conflicting way. A lack of concern for local conditions, however, can easily lead to a posture whereby the sector is content to play largely a brokerage role in the local context, neither actively encouraging nor discouraging development, but feeding upon such progress that may take place. Consistent with this role is an absence of risk-taking, over-cautiousness in lending and an excessive concern for liquidity and safety. In this climate, private enterprise becomes easily stifled with the result that the state (which tends to attract funds relatively easily) finds itself, often unwillingly, extending its economic activities, and usurping the role of private initiative and enterprise in many areas. Thus the posture adopted by the financial sector has a fundamental influence not only on the rate of growth, but on the direction of development and ultimately on the form which the economic system assumes. Financial institutions are in a position not only to frustrate national priorities and objectives but to encourage the economy to move along paths that have not been the subject of premeditated policy. In this respect, it is easy for undesirable distortions and relationships to arise, which sooner or later, become effective factors in hampering the development effort.

FOOTNOTES

1. In the context of a developing country, this factor would hardly be operative given the ethos of the institutions whose presence tend to be motivated more by what they can get out of the existing situation in terms of profit, rather than by any conscious desire to play an active part in changing the fabric of the economy, or stimulating its growth.

2. This may be the result not so much as a lack of finance as of the attitudes and principles on which financial institutions operate. Not only may there be an absence of the type of assets they would wish to hold locally, but even where there are opportunities for lending they may be reluctant to undertake the risks involved, or set up the infrastructure necessary for such lending. For these reasons the public sector may not find it difficult to borrow money from the financial system even when private borrowers are finding credit difficult to come by.

3. For a discussion on the uses of money within a theoretical framework see, K. Brunner and A. Meltzer, "The Uses of Money: Money in the Theory of an Exchange Economy", *American Economic Review,* December, 1971.

4. See, for example, John G. Gurley, and E.C. Shaw, "Financial Aspects of Economic Development", *American Economic Review,* September, 1955. See also R.W. Goldsmith, *Financial Structure and Development,* New Haven, Yale University Press, 1969.

5. Vincente Galbis, "Financial Intermediation and Economic Growth in Less Developed Countries: A Theoretical Approach", *The Journal of Development Studies,* January, 1977, Vol. 13, No. 2. (Special Issue on Finance in Development Countries).

6. See, for example, Edward S. Shaw, *Financial Deepening in Economic Development,* London, Oxford University Press, 1973. See also R.I. McKinnon, *Money and Capital in Economic Development,* Washington D.C., The Brookings Institution, 1973.

7. See, for example, W. Arthur Lewis, *Theory of Economic Growth,* New York, Harper and Row, 1970, pp. 224-225.

8. Given this kind of relationship financial assets tend to grow side by side with real assets. See Gurley and Shaw, *op. cit.*

CHAPTER 1

THE ECONOMIC, SOCIAL AND POLITICAL SETTING

Physical Characteristics and Demographic Features

The Bahamas or the Commonwealth of the Bahamas as it has been called since 1968, is a scattered archipelago comprised of 29 major islands, 661 cays[1] and 2,387 rocks amounting to 5,382 square miles, and stretching in a curve-like fashion over an area of 550 miles south westerly, between Florida and Haiti. Positioned between latitudes 20° 50′ and 27° 25′ north, and longitudes 72° 37′ and 80° 32′ west, (covering an area about 100,000 square miles) the northern part of the chain lies just about 60 miles off the Florida coast which is less than an hour away flying time from Nassau, the capital city. While coral formations abound in the area, the islands themselves are composed mainly of oolitic limestone.

> They *"are almost completely flat; the highest hills, in Cat Island, are hardly more then 200 feet in height and in most islands there is no land more than a hundred feet above the sea. Both for this reason and the porosity of the rock, there are absolutely no rivers or streams. The soil is fertile, but extremely thin, and lodged in shallows and 'banana holes' in the harsh limestone rock. In some areas, the ground is so split by interlocking caves and potholes up to 60 feet deep that is is impossible to traverse, let alone farm. Fresh water is found but only close to the surface, resting by some quirk of nature on the underlying salt water. Wells drilled too deep or worked too hard produce brackish or salt water".*[2]

Though the Bahamas has no resources of major importance that can be bought, sold and transported, the country is, nevertheless, well endowed with miles of white sandy beaches, clear warm waters and all-year mild climate that have made it one of the most sought-after resorts in the hemisphere.[3] The economic impact of the tourist industry will be discussed shortly.

Of the several hundred widely dispersed islands and cays that comprise the Bahamas, only about 30 are inhabited. The population is in fact highly concentrated as can be seen in Table 1.1. New Providence alone (which contains the capital city of Nassau) has 60 per cent of the country's residents. Taken with Grand Bahama, these two islands with 12 per cent of the land area contain over 75 per cent of the total population. On the other hand, Andros with 43 per cent of the land area has only 5 per cent of the

TABLE 1.1.

AREA AND POPULATION OF BAHAMA ISLANDS

Islands	Area Sq. Miles	Area % of Total	Population (1970) No.	Population (1970) % of Total	Population Per Sq. Mile
Abaco	649	12.1	6,501	3.9	10
Acklins Islands	192	3.5	936	0.6	5
Andros	2,300	42.7	8,845	5.2	4
Berry Island	12	0.2	443	0.3	37
Cat Island	150	2.8	2,657	1.6	18
Crooked Island	84	1.6	689	0.4	8
Exuma & Cays	112	2.1	3,767	2.2	34
Grand Bahama	530	9.8	25,859	15.3	49
Inagua	599	11.1	1,109	0.7	2
Long Island	230	4.3	26	0.0	17
Long Cay	9	0.2	3,861	2.3	3
Mayaguana	110	2.0	581	0.3	5
New Providence	80	1.5	101,503	60.1	1,269
Ragged Island	14	0.3	208	0.1	15
Rum Cay	90	1.7	856	0.5	10
Other Bahamas	221	4.1	10,971	6.5	50
Total	**5,382**	**100.0**	**168,812**	**100.0**	**31**

Source: *Report of the 1970 Census of Population,* Department of Statistics, Nassau.

population. This general pattern is reflected more starkly in the last column which shows the actual population density per square mile by island. While the density for the country, as a whole, is only 31, the comparative figure for New Providence is 1,269, giving not only an idea of the pressure that is being put on the resources of this island, but revealing one of the major dimensions of the problem facing the authorities viz., the flight by young people from the rural areas (islands) to the city in search of a 'better life'. This, of course, is a reflection of the pattern of development taking place which, as we shall see later, is heavily concentrated in one or two islands.

At this point there are two other aspects of the country's population on which some comments are required. One is its growth which has both a natural element and an artifical (immigrant) component. The other is its structure which, in a sense, defines the social demands on the country's resources and, hence, should provide a direct influence on government's policy. In the 20 years between 1953 and 1973 the population of the Bahamas is estimated to have increased by 105,000 or by 123 per cent as compared to about 25,000 or 42 per cent over the previous twenty years. The high growth rate was particularly noticeable in the decade between 1963 and 1973 which witnessed an expansion of 60,000 at an average annual rate of about 3.9 per cent as compared to 45,000 over the previous decade at about 4.3 per cent. While part of this expansion is attributed to natural increase as indicated before, there is no doubt that immigration has also been an important contributory factor. According to the last (1970) census there were some 26,000[4] (15 per cent of the population) non-nationals resident in the islands in 1970, the major countries of origin being (according to official data) the United States, Haiti, the United Kingdom, Jamaica and Canada in that order. Recent trends indicate that net migration continues to account for a substantial part of the increase in the Bahamian population. While between 1970 and 1978 the overall rate of increase was estimated to have been in the region of 3.6 per cent, the natural rate averaged around 2.4 per cent. The projected immigrant component in 1980 has been put at 27,000 or 11 per cent of the total estimated population.[5]

While the present population growth rate is almost twice the current world figure of just about 2 per cent, we need hardly state that population expansion means little outside the context in which it is taking place, in particular the availability of physical resources, the pace and level of development and the state of technology.

Some idea of recent trends in the relationship between the growth of population and the growth of income in the Bahamas can be derived from figures published by the World Bank.[6] According to this data, between 1960 and 1976, real per capita GNP grew at a rate of 0.6 per cent per annum, reflecting a slightly higher rate of expansion in real income than in population. This performance, it should be noted, however, was not uniform for the period.[7] The decade of the 1960s was a much more buoyant era than the 1970s which has been one characterised by stagnation or decline. Real per capita income is estimated to have fallen at a rate of 4.7

TABLE 1.2

GROWTH IN POPULATION OF THE BAHAMAS

1838 TO 1978

Selected Census Years	Total Population
1838	21,794
1901	53,735
1931	59,828
1943	68,846
1953	84,841
1963	130,220
1970	168,812
1973[a]	188,728
1978[a]	226,058

a: Mid-year estimates

Sources: *Report of the 1970 Census of Population,* Department of Statistics; *Population Projections for Bahamas until 1980,* Department of Statistics, Nassau.

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per cent over the period 1970 to 1976, and this undoubtedly would exert a downward pressure on the overall average growth rate.

As we shall see later, while there are several drawbacks to the use of per capita income as a measure of general well-being, the concept can serve to give a fairly good indication of the level of activity and the general state of the economy, particularly when used in conjunction with other data such as the level of unemployment, growth of government revenue, etc., which will be discussed shortly. True, the Bahamas may still have a great deal of available land space, but it is clear, in view of current economic trends and the existing pattern of population distribution, that further population growth can only be wisely encouraged within a broader development framework involving the outer islands whose potential is still largely unexploited.

As we have indicated earlier, another aspect of the country's population to which attention has to be paid in planning for the future is its age structure. An examination of the results of the 1970 census shows that the youth element is an outstanding feature. Of the 169,000 people living in the

TABLE 1.3

POPULATION (MID-1976) AND PER CAPITA GNP (1976) OF SELECTED COUNTRIES

Countries	Population '000	Per Capita GNP (At Market Prices) U.S. $
Switzerland	6,350	9,160
Bermuda*	54	8,290
Canada	23,025	7,930
United States	215,142	7,880
Japan	112,768	5,090
Saudi Arabia	9,240	4,420
Bahamas*	211	3,310
Isle of Man*	61	2,700
Singapore	2,278	2,580
Venezuela	12,361	2,540
Puerto Rico	3,210	2,310
Hong Kong	4,444	2,230
Trinidad & Tobago	1,098	2,190
Netherlands Antilles*	246	1,750
Barbados	247	1,620
Panama	1,718	1,170
Jamaica	2,072	1,150
Brazil	110,124	1,300
Mexico	62,025	1,060
Guyana	793	570
Liberia	1,600	410
Nigeria	77,056	400
India	620,440	140

*Estimates of per capita GNP are tenative.
Source: *World Bank Atlas,* 1978.

Bahamas in 1970, 74,000 or 44 per cent was less than 14 years, another 27,000 or 16 per cent fell in the 15 to 24 bracket, while the proportion in the 25–29 age group amounted to 8 per cent giving a total of 68 per cent of the population below the age of 30 years. According to one set of projections[8] it is estimated that by 1980 the structure would not diverge significantly from this pattern. In the first category (i.e. less than 14 years) the proportion has been put at 37 per cent while in the second and third the estimated contributions are 21 per cent and 8 per cent respectively. In other words, in 1980 it is estimated that 66 per cent of the population will be under 30 years.

Per Capita Product and the Distribution of Income

Figures published in the World Bank Atlas of 1978 show that the Bahamas, viewed either in a hemispheric or wider context, has attained a relatively high level of per capita income in recent years (see Table 1.3). With an estimated per capita GNP of over US $3,000 in 1976, this country was placed among 60 other states with a per capita product of over $2,000. It is estimated that there were 123 countries with an income below this latter figure. The national product data used for the Bahamas, it should be noted, are not based on any regular and comprehensive estimation system, and therefore, no doubt, incorporate a greater margin of error than is normally the case, the extent of which is difficult to detect from available statistics. There is ample evidence, however, to indicate that the growth performance experienced by the Bahamas in the post-war period has been a remarkable one, particularly when viewed in the light of conditions prevailing before the war.

Unfortunately, as is so often the case, particularly in poor countries with their unbalanced structures and heavy dependence on the outside world, growth, as reflected in total income, does not necessarily represent an improved standard of living for the broad masses of the population, to whom only a small part of the wealth generated may accrue from the production process. In the Bahamas, an analysis of the division of the total product between the local economy and the rest of the world, and the distribution of personal income at the territorial level strongly support the criticism commonly directed to impressions gleaned from aggregate data relating to economic performance and national welfare. An examination of Table 1.4 shows that while in recent years 'net factor payments' abroad as a proportion of GDP appear to be falling, in the period between 1969 and 1972, the ratio averaged 20 per cent. One suspects that the figure was much higher in earlier years. When we look at the distribution of the GNP, which includes income from abroad, a significant share goes to non-Bahamians. According to the 1970 Census figures, while the expatriate population comprised only 15 per cent of the population, they received 38 per cent of the country's total personal disposable income, while Bahamians who formed 85 per cent of the population received 62 per cent of the income. In average terms, this means that while the per capita income of the expatriate population was over $4,000, that of the Bahamian was

TABLE 1.4

NET FACTOR PAYMENTS ABROAD AS A PERCENTAGE (%) OF GDP, 1969 TO 1977
(Current Prices)

$ m.

	Income Aggregates	1969	1970	1971	1972	1973	1974	1975	1976	1977
1.	GDP at Market Prices	487.7	463.5	520.6	582.5	595.0	685.0	691.6	764.4	796.2
2.	Net Factor Payments Abroad	–87.8	–63.0	–110.7	–168.0	–81.2	–79.3	–61.6	–64.6	–44.2
3	GNP at Market Prices	399.9	400.5	409.7	414.5	513.8	605.7	630.0	700.0	750 0
4.	(2) in absolute terms as a % of (1)	18.0	13.6	21.6	28.9	13.6	11.6	8.9	8.4	5.5

Source: Central Bank of the Bahamas *Quarterly Review,* various issues. The national income figures are IMF and World Bank estimates. The net factor payments abroad for the period 1969 to 1972 are also World Bank estimates.

TABLE 1.5

QUINTILES OF HOUSEHOLD AND FAMILY INCOME
FOR THE BAHAMAS, 1970

Household/ Family	% of Total Income	Cumulative %
Lowest Fifth	2.9	2.9
Second Fifth	9.4	12.3
Third Fifth	14.6	26.9
Fourth Fifth	22.5	49.4
Highest Fifth	50.6	100.0

Source: Census Monograph No. 1, *Manpower and Income,* Department of Statistics, Nassau.

only $1,234. Hence, although the Bahamian population was nearly six times the expatriate population, their comparative earnings were only about one third that of the expatriate population.[9] Looking at the distribution for the resident community, as a whole, we observe in Table 1.5 that while the top 40 per cent of households received 73 per cent of personal disposal income in 1970, the lowest 60 per cent got only 27 per cent.

Since 1970 the redistribution of income has been increasingly in favour of Bahamians. In 1975 (the latest year for which we have data), for example, Bahamian households received 80 per cent of the estimated $315 million personal income as compared to 62 per cent five years earlier. In per capita terms the figure for Bahamians increased to $1,523 in 1975, while that of non-Bahamians fell to $1,632. As far as the distribution of income among residents is concerned, the situation appears to have grown more unequal. In 1975, it was estimated that whereas the top 41 per cent of households had 81 per cent of personal income the lowest, 59 per cent, received 19 per cent.

There are, of course, other difficulties involved in making welfare comparisons between countries on the basis of per capita income. It is not our intention here to discuss these problems except to point to one that is of particular importance where the Bahamas is concerned. This relates to the question of the price level which tends to be of a generally high order, and which is no doubt significantly influenced by the present fiscal system. The latter is discussed in a later chapter.

TABLE 1.6

SECTORAL COMPOSITION OF GDP AND DISTRIBUTION OF EMPLOYED LABOUR FORCE BY ACTIVITY, 1970

Sectors	GDP at Factor Cost B$m.	%	Employed Labour Force No.	%
1. Agriculture, Forestry and Fishing	14.1	3.6	4,791	7.7
2. Mining & Quarrying	2.8	0.7	78	0.1
3. Manufacturing & Processing	35.1	9.0	3,824	6.1
4. Construction	56.7	14.5	8,469	13.6
Sub-Total	**108.7**	**27.8**	**17,162**	**27.5**
5. Electricity, Gas & Water	10.7	2.7	1,329	2.1
6. Wholesale Trade	13.5	3.4		
7. Retail Trade	14.8	3.8	16,157	25.9
8. Hotels & Restaurants	76.1	19.4		
9. Transport, Storage & Communications	45.4	11.6	5,512	8.8
10. Finance, Insurance, Real Estate & Business Services	50.1	12.8	5,331	8.6
11. Community, Social & Personal Services	72.4	18.5	16,873	27.1
Sub-Total	**283.0**	**72.2**	**45,202**	**72.5**
Grand Total	**391.7**	**100.0**	**62,364[a]**	**100.0**

a: This figure amounted to 89 per cent of the 'potentially economic active population' which was put at 69,791 in 1970. Since this concept was defined to include those temporarily unemployed because of ill-health, as well as those unemployed for other reasons, the remaining 11 per cent does not really reflect an accurate picture of the unemployment situation at the time.

Source: *Report of the 1970 Census of Population*, Department of Statistics; the GDP figures are World Bank estimates.

Tourism and the Economy

It is instructive to note that the major source of the Bahamas post-war economic upsurge has not arisen from any structural transformation in the production base of the economy, or from the exploitation of a valuable mineral resource, as has been the case in some developing countries, but from the extraordinary expansion of a service industry, viz., tourism which is now the main basis of economic life in the country. An exercise carried out in 1968, at the invitation of the government, estimated that the contribution from this source to Gross National Product (GNP) amounts to roughly 71 per cent, while providing employment, directly and indirectly, for about two-thirds of the labour force. [10] A recent World Bank study [11] has come close to supporting the former figure, giving estimates of 55 per cent to GDP and 77 per cent to GNP, while the results of the 1970 Census of population indicate that the employment contribution might be between 50 and 60 per cent (See Table 1.6). In terms of foreign exchange earnings, the dominant role of tourism can easily be seen in Table 1.7. The oil trade, as we shall see later, is largely an offshore operation, and except for certain local disbursements, can easily be ignored from a foreign exchange point of view. In 1977 the gross earnings from the tourist industry were estimated to be $407 million which was equal to 50 per cent of foreign earnings (excluding oil) and 60 per cent of the exports of goods and non-factor services.

While the Bahamas has always had its sun, sea and sand, it is only in the period following the Second World War that tourism grew to a position of any preeminence. This can be seen to some extent in Table 1.8, which shows that the number of visitors grew from about 16,000 in 1946 to over one million in 1968. Since then, the growth has slowed, though the general trend has been upward with fluctuations from year to year. Concomitant with the increase in numbers, total tourist expenditure has also been expanding, rising from a gross of $180 million in 1968 to $508 million in 1978. The total number of hotel rooms increased from 2.5 thousand in 1959 to 11.6 thousand in 1973. Since then the number of available rooms has actually been falling, reflecting the over-capacity in the industry in recent years.

There are a number of features characteristic of the Bahamian tourist industry which need to be noted. The first is that not all the islands have benefited equally from the boom in the post-war period. New Providence (including Paradise Island) and Freeport tend to receive over 80 per cent of the visitors to the Bahamas. The out islands' share appears to be growing in recent years but the concentration of the industry in terms of accommodation facilities can be seen in the fact that of the 11,000 hotel rooms available in 1978, 82 per cent were located in New Providence (including Paradise Island) and Grand Bahamas. A second and very prominent characteristic of the industry is its high dependence on the U.S. market from which, on average, over 80 per cent of visitors to the Bahamas originate (See Table 1.9). While there are some signs that European holiday seekers are beginning to be attracted, the numbers are still very small compared to

TABLE 1.7

THE BALANCE OF PAYMENTS (CURRENT ACCOUNT) 1974 TO 1978

$m.	1974		1975		1976		1977		1978[a]	
	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit
Oil Trade	1,672.6	1,797.6	2,099.7	2,251.4	2,466.7	2,613.8	2,439.0	2,566.5	1,971.8	2,119.3
Other Merchandise (f.o.b)	122.8	286.1	116.2	209.6	134.9	251.8	138.7	268.0	155.1	308.9
Freight & Insurance	–	23.6	–	17.3	–	20.9	–	21.8	–	25.0
Non-Merchandise Insurance	–	2.5	–	3.6	–	4.1	–	6.0	–	6.4
Travel	323.8	44.6	312.7	45.6	363.1	43.8	407.2	54.4	508.2	61.0
Transportation	69.9	19.9	91.6	22.8	93.0	17.0	76.5	23.1	88.5	32.5
Interest, Dividends and Profits	129.6	208.9	125.6	187.2	117.9	182.3	134.5	178.7	297.3	379.7
(of which Banks & Trusts)	(124.3)	(143.4)	(120.1)	(98.7)	(113.8)	(109.6)	(130.9)	(105.1)	(291.0)	(277.7)
Offshore Cos' Local Expenses	34.5	–	47.6	–	40.2	–	33.8	–	36.2	–
Other Transactions	12.2	62.6	14.1	46.5	16.5	51.2	19.1	58.1	26.6	67.3
Transfers:										
Private	1.0	18.0	0.9	15.8	1.1	17.6	1.2	19.8	1.1	23.3
Government	5.4	0.9	5.6	0.9	6.1	1.2	6.0	0.6	8.0	0.4
Total	2371.8	2,464.7	2,814.0	2,800.7	3,239.5	3,203.7	3,256.0	3,197.0	3,092.8	3,023.8
Balance on Current Account	– 92.9		+ 13.3		+ 35.8		+ 59.0		+ 69.0	
Balance on Capital Account	+118.1		+ 38.0		+ 7.1		+ 39.4		–25.8	

a: Provisional.

Source: Central Bank of the Bahamas, *Quarterly Review*, various issues.

TABLE 1.8

GROWTH OF TOURISM IN THE BAHAMAS IN THE POSTWAR PERIOD

Year	Number of Visitors Total[a]	Of Which Stopover	Hotel Rooms Available[b]	Visitor Days	Total Expend[c].	Expenditure Per Tourist
	'000	'000	'000	m.	$m.	$
1946	15.6					
1947	30.7					
1948	34.8					
1949	32.0					
1950	45.4					
1951	68.5					
1952	85.7					
1953	90.5					
1954	109.6					
1955	132.4					
1956	155.0					
1957	194.6					
1958	177.9					
1959	244.3		2.5			
1960	345.0		2.6			
1961	368.2		2.9			
1962	444.9		3.4			
1963	546.4		3.5			
1964	605.2		4.5			
1965	720.4		5.4			
1966	822.3		6.0			
1967	915.3		8.2			
1968	1,072.2	819.9	8.3	4.750	180.3	168
1969	1,307.4	970.3	9.5	5.472	235.1	180
1970	1,243.3	916.5	9.6	5.242	230.1	185
1971	1,396.6	971.0	10.8	5.419	274.8	197
1972	1,443.4	1,015.3	11.2	6.264	280.9	195
1973	1,439.1	976.8	11.6	6.375	302.0	210
1974	1,315.9	929.2	11.6	6.479	323.8	246
1975	1,324.3	903.0	11.4	6.228	312.7	240
1976	1,344.5	939.9	11.0	6.310	363.1	271
1977	1,318.4	965.4	11.3	6.721	407.2	309
1978	1,625.7	1,176.1	11.0	8.192	508.2[d]	312

Note: An incomplete series reflects the unavailability of data for the years concerned.

a. The figures until 1967 include stopover, cruise and transit visitors. The latter category is excluded from the figures that follow. Data on visitors to the out islands prior to 1960 are not available, but this would not significantly affect the total figures since the trade in this period was extremely small.

b. Rooms of licensed hotels, guest houses and cottages available at the end of each year.

c. For the later years we have used estimates as they appear in the balance of payments table published by the central bank on its *Quarterly Review.* These figures often differ slightly from those put out by the Ministry of Tourism.

d. Provisional

Sources: Colonial Office Reports; *Annual Reports* of the Ministry of Tourism; *Statistical Abstract,* various issues, Department of Statistics, Central Bank of the Bahamas, *Quarterly Review,* various issues.

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the American component which is always likely to remain significant, given the proximity factor, even though the relative share may decrease in the future. Europeans (excluding U.K. residents) accounted for 5 per cent of total visitors in 1978 as compared to 3 per cent in 1974 and 1 per cent in 1971. The share of the Canadian component has tended to remain steady at around 12 per cent in recent years. In 1978 the figure dropped slightly to 10 per cent. A feature to be noted with respect to Bahamian tourism in recent times is its somewhat unseasonal character. A glance at Diagram 1.1 will show that while there are certainly some peak months (e.g. March) and through periods (e.g. September), tourism is an all year business.

The growth of tourism in the Bahamas has been the consequence of several factors and it is important to identify these in trying to evaluate the performance and behaviour of the industry in recent years. One of the most important has, undoubtedly, been the tremendous promotional campaign which successive administrations have pursued since the early '50s in overseas efforts aimed at attracting visitors and investors. Even today the Ministry of Tourism (the Development Board before 1964) which is a key Ministry in the governmental structure still takes over 5 to 10 per cent of the current budget, the 1979 allocation amounting to more than five times the funds put at the disposal of the Ministry of Agriculture and Fisheries. Another important and critical factor which added impetus to Bahamian tourism in the period under discussion was the establishment of modern airport facilities and the initiation or regular air (and sea) links

TABLE 1.9

COUNTRIES OF VISITORS' RESIDENCE AND ARRIVALS BY FIRST PORT OF ENTRY.[a] 1965 TO 1978

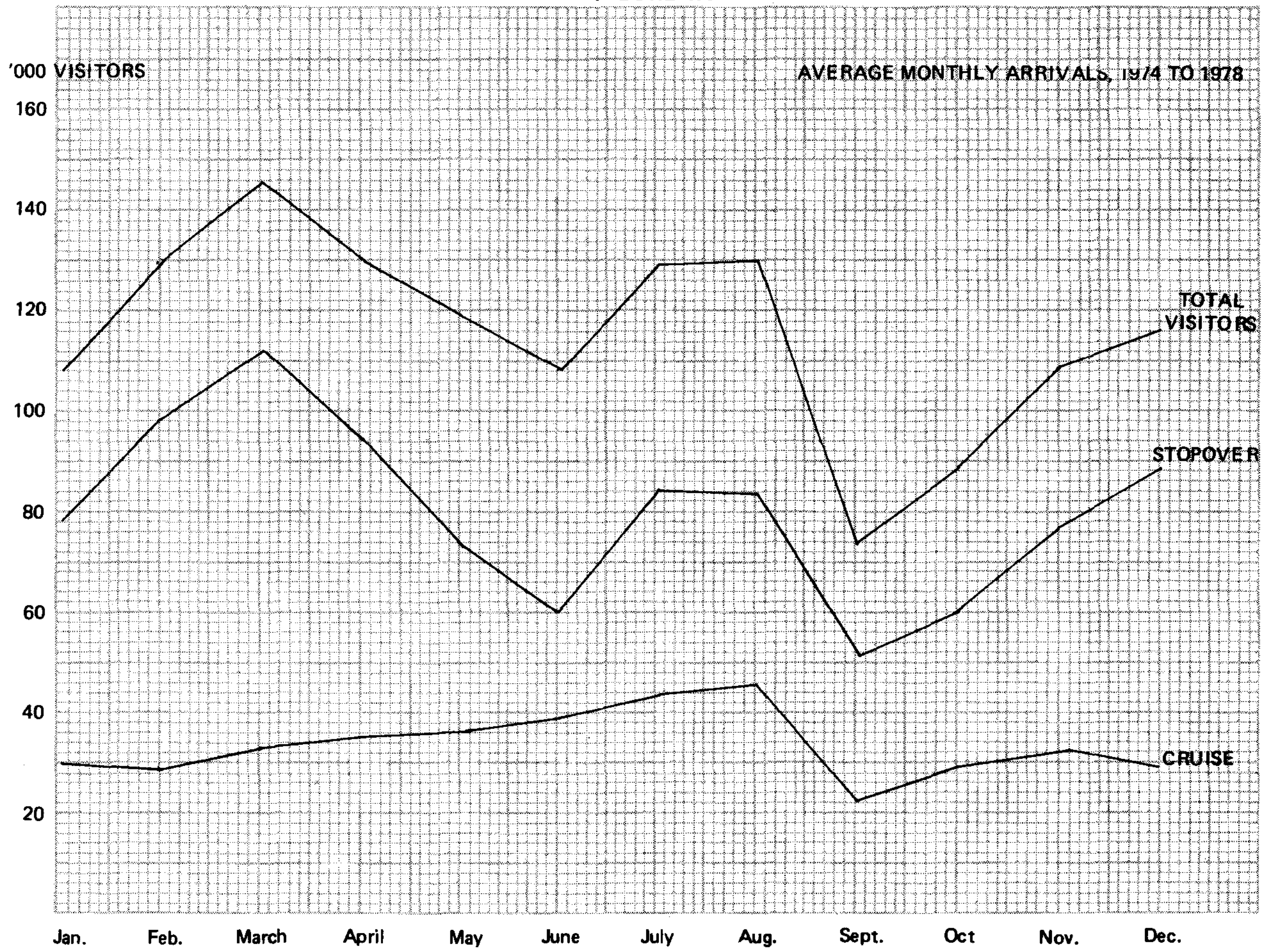
	Points of Residence (%)						First Port of Entry (%)			
Years	U.S.A.	Canada	U.K.	Other W. Europe	Total Countries	Total	Nassau	Freeport	Out Islands[b]	Total
1965	78	10	5	–	7	100	69	20	11	100
1970	87	5	1	2	5	100	56	35	9	100
1971	88	5	1	1	5	100	57	34	9	100
1972	86	7	1	2	4	100	62	28	10	100
1973	84	9	1	2	4	100	65	24	11	100
1974	80	12	1	3	4	100	67	21	12	100
1975	78	12	1	4	5	100	66	21	13	100
1976	79	12	1	4	4	100	63	23	14	100
1977	79	12	1	4	4	100	63	21	16	100
1978	81	10	1	5	3	100	60	24	16	100

a. "First Port of Entry" reflects where visitors enter the Bahamas and not particularly where they stay.

b. Includes West End (Grand Bahama).

Source: *Annual Reports,* Ministry of Tourism.

FIGURE 1.1



'000 VISITORS
AVERAGE MONTHLY ARRIVALS, 1974 TO 1978
160
140
120
100
80
60
40
20
TOTAL VISITORS
STOPOVER
CRUISE
Jan.
Feb.
March
April
May
June
July
Aug.
Sept.
Oct
Nov.
Dec.

with population centres in North America and Europe. A third and fortuitous development was the isolation of Cuba from the inter-American system in the early 1960s. The inability of Americans to travel to that country and the almost simultaneous introduction to casino gambling into the Bahamas diverted a great part of the Cuban business to the Bahamas which was already beginning to attract the attention of American holiday and pleasure seekers. A fourth, and not the least important of the factors mentioned, has been the role of foreign private capital in the whole post-war effort, starting with the inflow of British capital just after the end of the Second World War, and later with the influx of finance from other sources, (particularly the United States) responding to the introduction of the 1949 Hotels Encouragement Act which provides for customs and other tax benefits to investors.[12]

Deliberate attempts to foster industrial development and attract foreign investors by offering tax incentives of various kinds can be traced back to 1951 when the Legislature passed the Industries Encouragement Act (No. 27 of 1951), with a view to attracting and encouraging manufacturers, aiming mainly at foreign markets. In 1955, further incentive was provided in the form of the Hawksbill Creek Agreement (discussed later) which offers exemption from taxes on income, capital gains, real estate and personal property until 1990, as well as granting freedom from customs duties (except on imports for personal use), excise and stamp duties until 2054.[13] In 1970, the Progressive Liberal Party (P.L.P.) Government, in the wake of rumours of impending taxation and growing concern over the heavy dependence on tourism, adopted a new Industries Encouragement Act (No. 10 of 1970) which, in addition to providing protection against import taxes and duties on essential requirements (e.g. plant machinery, tools, equipment, raw materials etc.), offers complete exemption on all earnings for 15 years to approved enterprises. Given the absence of income and corporation taxes in the Bahamas, this latter provision is nothing more than a guarantee, in the event that such measures are introduced in years subsequent to the establishment of the enterprise.

Despite the existence of these incentives which are further bolstered by the operation of a liberal exchange control regime promising easy repatriation of assets, profits and dividends and the provision of factory sites and related facilities, the Bahamas has not been very successful in attracting manufacturing enterprises. The industrial sector, at the moment, comprises for the most part, a few [14] highly capital intensive plants (all foreign-owned and almost all sited in Freeport) drawing their inputs from abroad and producing mainly for external markets.

In terms of investment and employment, the largest of these enterprises is the Bahamas Oil Refining Company (BORCO) owned by the Charter Oil Company and Standard Oil of California, and located in Grand Bahama. The company which started operations in 1970 with an investment of $100 million (expanded since to $300 milion) has a capacity of 500,000

TABLE 1.10

SELECTED DATA ON MAJOR INDUSTRIES

Name of Company	Product Manufactured	Owners	Estimated Capital Investment $m.
Bahamas Oil Refining Co.	Petroleum products	Charter Oil Company (50%) and Standard Oil of California (50%)	300
Bahama Cement Company	Cement	International Development Corporation ofLuxembourg (Arab owned)	75
The American Syntex Corp.	Steroid hormones and Naproxen	The American Syntex Corp. (U.S.)	21
Barcardi & Co. Ltd.	Rum	n.a.	12
Ocean Industries	Aragonite	Marcona Corp. (U.S.)	35
Diamond Crystal	Salt	Diamond Crystal Co. (Michigan, U.S.)	5
Morton Salt Co.	Salt	Morton International Ltd. (Chicago, U.S.)	10
Cooper Laboratories	Anti-virus drug (Protamide)	n.a.	n.a.
Todhunter Mitchell & Co. Ltd.	Rum	U.S.	n.a.
Grand Bahama Steel and Pipe	Steel pipes	Klockner & Co. 80% (W. Germany)	3

Source: Bahamas Development, Corporation, *Financial Times Survey,* various issues.

barrels per day, which is used for refining imported crude for re-export, mainly to the nearby United States. Though not producing any of its own, the Bahamas is connected with oil in another way. This takes the form of a joint venture transhipment terminal (costing $55 million) between the government-owned Bahamas Development Corporation and Burmah Oil Tankers and also located in Grand Bahama. Both these operations have been affected by recent developments in the international petroleum market. BORCO was set up to supply the United States with low sulphur fuel, but the dismantling of many of the environmental controls stemming from the post-war energy crisis has resulted in a falling off in the demand for the products of this refinery. In addition, the new regulations relating to oil imports into the United States tend to favour refineries in U.S. possessions, even when operations in non-U.S. territories are American owned. The Burmah terminal was apparently conceived in the production and marketing situation prevailing in the pre-crisis days of the very early 1970s when the supply/demand conditions for petroleum provided a strong economic rationale for a transhipment centre. It is believed that the very existence of this terminal may be threatened by competitive developments elsewhere in the hemisphere.[15]

The cement plant, operating since 1964, was established with a capital investment of $75 million by the U.S. Steel Corporation. It has a capacity of 850,000 short tons. As a result of financial difficulities, the company was closed in 1977 but resumed operations the following year under the ownership of the International Development Corporation of Luxembourg, an Arab concern.

There are two drug producing companies, the American Syntex Corporation (which manufactures Naproxen, a drug used in the treatment of arthritis, and steroid hormones used in the production of oral contraceptives) and Cooper Laboratories which makes the anti-virus drug, Protamide. Other ventures include rum manufacturing and bottling plants, a blending operation and a steel pipe company. In addition to these industries there are a number of small manufacturers engaged in the production of perfumes, canned juices, paints, textile hand prints, mattresses and cement tiles.

Mining

At the moment, the mining sector in the Bahamas comprises salt extraction (in which two United States corporations are engaged), and aragonite exploitation. Aragonite is a pure form of calcium carbonate, chemically similar to high calcium limestone. Unlike the latter, however, which normally takes the form of hard rock, aragonite (named after the Spanish kingdom of Aragon where it was discovered) is more sandlike in appearance. With its chemical properties, this resource has a variety of uses being employed in the manufacture of cement, steel, glass, pulp and paper, chemical lime, agricultural fertilisers and a source of CO_2 in carbonated soft drinks.

Reserves are believed to be in the region of 50,000 million tons and operations are currently being carried out by a foreign corporation. Royalities are paid to government in accordance with an agreed formula and schedule. In 1978, the contribution to government's estimated revenue amounted to $300,000 (or less than 1 per cent of total tax income). Though this figure may increase as production expands and operations become more profitable, the financial contribution to public revenue is not likely to assume any great significance, given the low value nature of this mineral.

Although there is clearly some scope for increasing the local contribution from aragonite exploitation, particularly in terms of revenue and the possible linkage effects in stimulating related industries with all that this implies in the context of employment creation and foreign exchange savings and earnings, aragonite does not have the same rich possibilities of say, oil or bauxite.

The importance of these industries in the export trade of the country in recent years can be seen in Table 1.11 which shows that the foreign dominated manufacturing sector now accounts for over 90 per cent of the country's total domestic exports. It is worth noting, as indicated earlier, that the oil business is largely an 'offshore' one with little linkage to the domestic economy. Excluding oil products, total domestic exports increased from $41 million in 1971 to $87 million in 1977. The major contributors in the latter year were chemical products with $51 million (59 per cent), crude salt and aragonite with $41 million (16 per cent), rum and cement with $10 million (12 per cent) and crawfish with $9 million (10 per cent).

Taken together, the manufacturing sector is estimated to have contributed $35 million or 9 per cent to gross domestic product (at factor cost) in 1970. Although with the expansion in plant facilities and production that have taken place since, this position has probably improved, both absolutely and in relative terms, the contribution vis-a-vis tourist related activities is still no doubt very insignificant. As far as employment is concerned the sector, in 1970, employed 3.8 thousand people (see Table 1.6) or about 6 per cent of the employed labour force and 5.4 per cent of the 'potentially economic active population'. According to the Labour Force Report[16] of 1975, the number of persons employed by the manufacturing sector in that year dropped by 1.2 thousand or to 1.8 per cent of the people employed and to 1.4 per cent of the 'potentially economic active population'. As pointed out earlier, non-Bahamians form a relatively large proportion of the Bahamian labour population, amounting to 24 per cent in 1970, 12 per cent in 1973 and 13 per cent in 1975. As can be seen in Table 1.12, of the 1.2 thousand persons actually employed in the manufacturing sector in 1975, 300 or 25 per cent were non-Bahamians. In 'Mining and Quarrying' the ratio was over 40 per cent.

Given the advantage of proximity to the big U.S. market, one would have thought that a larger number of manufacturing plants would have

TABLE 1.11

MANUFACTURED GOODS IN THE EXPORT TRADE OF THE BAHAMAS 1969 TO 1977

B$m

Year	(1) Total Dom. Exports	(2) Mineral Fuels & Related Materials	(3) Crude Salt	(4) Hormones	(5) Cement	(6) Rum	(7) Aragonite	(8) (2) to (7)	(9) (8) as a % of (1)
1969	54.3[a]	0.5	1.9	–	1.7	3.5	0.0	7.6	14.0
1970	89.6[a]	32.0	2.8	4.5	11.1	2.7	0.0	53.1	59.3
1971	247.3	204.7	3.7	15.7	13.2	5.4	0.0	242.7	98.1
1972	321.7	252.0	3.6	28.2	15.4	11.4	2.3	312.9	97.2
1973	406.2	337.5	3.0	22.1	16.7	15.9	3.4	398.6	98.1
1974	1,008.3	926.2	4.1	38.0	15.0	13.7	4.0	1,001.0	99.2
1975	1,230.4	1,172.7	4.0	26.0	6.9	13.6	2.9	1,226.1	99.6
1976	925.8	849.7	8.4	38.7	6.8	10.3	8.4	922.3	99.6
1977[b]	408.5	321.0	7.0	38.6	1.6	8.2	6.5	382.9	93.7

a: Includes re-exports.

b: Provisional.

Source. Central Bank of the Bahamas, *Quarterly Review,* Dec., 1978. Department of Statistics.

TABLE 1.12
EMPLOYED PERSONS BY TYPE OF INDUSTRY AND BY NATIONALITY, 1975

Economic Activity	Number			Percentage		
	Bahamian	Non-Bahamian	Total (%)	Bahamian	Non-Bahamian	Total
Agriculture, Hunting Forestry & Fishing	4,596	816	5,412 (8.1)	84.9	15.1	100.0
Mining & Quarrying	427	342	769 (1.2)	55.5	44.5	100.0
Manufacturing	919	300	1,219 (1.8)	75.4	24.6	100.0
Electricity, Gas and Water	1,551	298	1,849 (2.8)	83.9	16.1	100.0
Construction	2,068	215	2,283 (3.4)	90.6	9.4	100.0
Wholesale and Retail Trade	7,354	430	7,784 (11.7)	94.5	5.5	100.0
Restaurants and Hotels	9,250	1,201	10,451 (15.8)	88.5	11.5	100.0
Transport, Storage and Communication	4,826	341	5,169 (7.8)	93.4	6.6	100.0
Financing, Insurance Real Estate & Business Services	4,194	645	4,837 (7.3)	86.7	13.3	100.0
Community, Social & Personal Services	22,062	4,295	26,357 (39.7)	83.7	16.3	100.0
Unknown	205	83	288 (0.4)	71.1	28.9	100.0
Total	**57,452**	**8,966**	**66,418 (100.0)**	**86.5**	**13.5**	**100.0**

Source Department of Statistics, *Labour Force Report,* 1975.

been attracted to the Bahamas, particularly in view of the exchange control arrangements and tax free situation which are undoubtedly more liberal than those of most countries in the hemisphere, where similar devices have been used to lure foreign investors. It is clear, however, that the absence of a skilled and abundant labour force and the high wage and salary levels obtaining in the country are too strong a deterrent, confirming the view, often expressed, that considerations, other than freedom from taxes, can have a more important influence in the location decision. Given the small size of the domestic market, the bulk of whatever is produced (except in cases, of course, where the objective is to satisfy local demand) would have to be exported, and hence the element of competitive prices is critical in this situation.

The importance of the labour and skill factors in the process of industrial development comes out very clearly in the case of Hong Kong (particularly so in view of the fact that this latter country operates a corporation profits tax of 17 per cent) which has many features in common with the Bahamas, including the laissez-faire type policy and the open invitation to foreign investors. Hong Kong, with a population of 4 to 5 million people, is a small mountainous country of about 400 square miles. Though possessing neither raw materials nor mineral resources of any major significance, this British colony has been able to make significant industrial progress in the period since the Second World War. Such studies[17] of this 'success story' as has been done, indicate that a major ingredient in Hong Kong's industrial growth has been the low labour cost, made possible by an elastic supply of labour and an ineffective trade union movement. Other important factors of course, include the capital, skill and entrepreneurial talent which came with the refugees fleeing mainland China in the latter 1940s. This influx itself was important in that it created the necessary pressures for the emergence of new activities in the face of Hong Kong's declining entrepôt trade which was the major source of economic sustenance in the pre-war years. It would appear, therefore, that while Hong Kong is a special case, being the result of an almost unique set of political and institutional circumstances, it does bear out our earlier statement about the importance of a skilled and abundant labour force in the industrialisation effort.

In discussing the industrial prospects of the Bahamas, there is a further consideration which needs to be mentioned, and it is this. Assuming that government policies were to succeed in attracting manufacturers (foreign or local) intent on producing for the local market, thus providing substitutes for goods currently being imported, this would immediately tend to raise a problem of another kind for the authorities. Since a substantial proportion of government's revenue is derived from import duties, any development which succeeds in reducing income from this source would have the effect of forcing the administration into looking for new sources of revenue, particularly in view of the increasing demands being made upon it. Under a fiscal system with the flexibility to provide the government with an increasing share of whatever income is generated, this is no great problem.

In a situation, however, as is the case in the Bahamas where the government has pledged itself to retaining the tax haven regime, quite a serious dilemma will materialise in the event of any substantial reduction in imports, particularly of those commodities which contribute significantly to government's income.

From the foregoing discussion, it is evident that in the anxiety to achieve some diversification in the economy, there has been a failure to conceptualise fully the implications of particular approaches to industrial development. The largely enclave sector which has emerged, besides being very tenuous, appears to offer no significant potential for income generation, employment creation or foreign exchange earnings viewed in net terms. In other words, it has not helped the diversification process in any major way. The current unemployment experience and the continued heavy reliance on foreign personnel, at the same time, suggest the need for a broad range of policies which could lead to a deeper involvement of Bahamians in functions and activities which have long been the preserves of foreigners. In this connection, the industrial potential arising out of the tourist industry itself needs to be more fully explored, not only in terms of creating linkages, but also in the interest of reducing the foreign exchange leakage associated with the industry. A necessary step in this direction appears to be clear identification of the possibilities since this knowledge can serve to inform the scope and nature of training, technical assistance, credit facilities etc., which are pre-requisites in the development of entrepreneurial talent.

The Freeport Project

Our discussion on industrialisation in the Bahamas will not be complete without some reference to the developments which have taken place in the second largest city of the country, Freeport where almost all the industries are located. Freeport, as the name implies, was first conceived as a 'free port' by an American citizen, named Wallace Groves. He saw in its location on major Western Hemisphere shipping lines and its proximity to North American, Caribbean and Latin American markets enough potential for a major venture.[18] To carry out his plans, an agreement was negotiated with the then Bahamian government in 1955, which gave to his company (the Grand Bahama Port Authority) exclusive rights to develop 50,000 acres of unused Crown lands, control over employment and the power to guarantee business concerns exemption from taxes on income, capital gains, real estate and personal property for 35 years after the signing of the Agreement, i.e. until 1990. Licensees[19] are also further entitled to exemption from import duties (except on consumable items), excise, export and stamp duties during the life of the Agreement which comes to an end 99 years from 1955, i.e. in 2054.

Within five years of the signing of the original agreement, not only did the area under the Port's control increase to 138,000 acres (about 40 per cent of the island of Grand Bahama), but the project itself took on a more ambitious dimension, extending its scope from a more or less strictly industrial and commercial complex to the construction of resort facilities and residential and shopping areas including the development of golf courses and other social amenities. With the introduction of casino gambling in the early 1960s and the construction of a deep water harbour in addition to the provision of certain basic infrastructures such as water, electricity and telephone services, the area soon developed a phenomenal momentum which continued right up until the end of the 1960s.

The number of visitors to Freeport increased from 27,000 in 1963 to more than half a million in 1971[20], while the population itself swelled from as estimated 150 in 1956 to over 15,000 in 1970. Of the latter figure, it should be noted, more than half are of foreign origin, brought in to run the industrial and commercial concerns located in the area. The widening gap between Freeport and the rest of the Grand Bahama, on which the city is located, can be seen in the fact that, whereas the per capita personal income in the former area was $3,794 in 1970, the corresponding figure for the latter which contained 41 per cent of the island's population (21 per cent of which were of non-Bahamian origin), was only $1,662.

Concerned over the wide powers granted to the Port Authority by the former United Bahamian Party (UBP) Government, and convinced of racial discrimination being practised in employment and housing, as well as the failure to carry out a firm commitment to train Bahamians, the PLP administration, soon after its election to office, gave notice of its intention to re-establish control over immigration in the Freeport Area and to amend the Hawksbill Creek Agreement, if found necessary to do so. This decision, not unexpectedly, created a great furore, the reverberations of which are still being heard, as the critics of the administration seek to attribute the down turn in activities in the area directly to the Government's action which was carried out in 1970. The latter, for its part, has rationalised its decision on the wish to obtain for Bahamians a larger share of the benefits, and on the need for exercising a degree of control over the direction of development.

The loss of momentum during the 1970s in this industrial enclave may have resulted partly from the uncertainty stemming from Government's policies. Other causes relate to the American recessions, the protectionist tendencies in the developed countries and anticipated problems in the local labour supply situation. Certainly, there has been no fundamental change in the original Freeport concept, apart from the political action mentioned.

The Agricultural Sector

As indicated earlier, the islands of the Bahamas, with their limestone formation and thin soil covering, are not ideally suited for agriculture. Yet over the years it has been possible to grow a wide variety of crops (e.g. corn, tobacco, citrus, cucumber, sisal, tomatoes, pineapples and cotton) both for the local market and for exports,[21] providing employment and support for the vast majority of the local people who chose to stay in the islands. Of the 3½ million acres of land that comprise the Bahamas, half a million are estimated to have a high agricultural potential.

With the emergence of tourism in the 1960s, and given the relatively lower returns[22] from agriculture, there has occured a natural and rapid movement of manpower resources away from the latter to the former, with the result that both in absolute terms and as a percentage of the total labour force, this sector now employs less people than it did in earlier years. For example, in 1963 the number of persons engaged in agricultural, fishing and forestry pursuits was estimated to be around 8,000 or 15.4 per cent of the labour force as compared to 5,975 and a proportion of 8.9 of the employed population (or 7.1 of the potentially economically active population) in 1975. While there has been a worldwide tendency for young people to desert the rural communities in favour of urban centres, there is no doubt that the present attitude towards the agricultural and fishing sectors and the consequent unsatisfactory performance which now obtains, has been significantly affected and shaped by official policies over the years. These policies have displayed a pathetic short-sightedness in the placement of priorities and the allocation of resources within the broader framework of achieving some balance in the economy.

The inability of the domestic food producing sectors to satisfy the growth in the demand stemming from both the increase in population and the expansion in tourism has led to a rapid rise in the food import bill. Food (including live animals) increased from less than $30 million in the early sixties to $48 million in 1969 and to $70 million in 1976. On average, imports satisfy about 85 per cent of total requirements. This means that the country meets only about 15 per cent of its needs from local sources. In terms of foreign exchange earnings food products account for a very small proportion of total income. In 1977, agricultural and marine products amounted to $10 million or to less than 2 per cent of total exports of goods (excluding oil) and non-factor services.

Concern over heavy dependence on tourism has, in recent years, given rise to a number of studies and experiments aimed at assessing the potential for agricultural, fisheries and livestock development in the Bahamas, with particular emphasis on the most suitable methods that can be employed under Bahamian conditions. Based on the results of these exercises and a conviction that the Bahamas can supply at least 50 per cent of its food requirements, (in fact with respect to certain items it is felt the country can attain self-sufficiency), there appears to be a growing commitment [23] to the encouragement of the food producing sectors, though no overall framework has yet been articulated. Some of the major problems, however, have clearly been identified.[24] These relate to marketing techniques and facilities, the need for a land policy, the provision of technical assistance and the availability of credit, all of which are crucial to the transformation of the Bahamas' traditional economic activities into a dynamic and modern sector capable of making a more significant contribution to the growth of the country.

Given the obvious need to develop a diversified economic structure with a high degree of sectoral inter-relationship, ad hoc and piece-meal approaches to agriculture (and fishing) will have to be replaced by a comprehensive long term programme formulated within broader economic policies and aimed at a more rational use of the country's limited resources. The whole spectrum of government's policies with respect to production, employment, finance, foreign exchange etc. will prove to be most efficacious within a framework of complementary action operating against a set of well-defined goals and objectives.

The attitudes of many developing countries towards agriculture in the post-war period have been of an uncertain, if not ambivalent, nature and this has led to the adoption of postures and policies which have contributed, in no small measure, to the stagnation or decline of this activity in many instances. The association of development with industry relegated agriculture to no more than a supporting role, undeserving of any deliberate effort to enhance its position as a pivot for a higher standard of living. Strategies based on this perception are fast coming under serious review in situations where the economic structure has undergone no fundamental transformation and where dependence has been more strongly entrenched or merely changed its forms. The encouragement of agriculture is now being seen as an integral part of the whole process of development, capable of contributing to income, employment, production and foreign exchange.

On the question of agricultural development, there is a final point we should make. It has been argued by some people that since it is cheaper to import many categories of food items than to produce them locally, this justifies the traditional low priority accorded the agricultural sector. This argument clearly has much in common with the old 'chicken and egg' controversy. For, it may well be that in many instances the relatively high cost of domestic production is more the consequence of lack of proper organisation, inadequate incentives, absence of relevant and up-to-date techniques, etc.(in other words, of neglect) rather than of any inherent feature which defies solution.

It should be borne in mind, too, that continued dependence on foreign sources for goods which could be produced locally uses foreign exchange resources which might be better allocated from a long term point of view. Greater domestic reliance also has the advantage that it makes the level of consumption less dependent on foreign exchange availability and, therefore more insulated from the vagaries which this variable experiences from time to time.

The Financial Sector

Since this sector will be discussed in great detail in the chapters that follow, a few broad remarks will suffice at this stage. Financial activities in the Bahamas are made up basically of two components, a domestic and a foreign or 'offshore . And, while it is difficult to delineate the precise contributions made by each to major economic aggregates, there is no doubt that, overall, the sector has experienced a fairly rapid growth over the last two decades. This has been helped by the fact that in the Bahamas financial activity is not merely seen as a means to an end but is encouraged as an end in itself. That is, as a sector that can generate income and employment and also enhance the tax image of the country. In 1970, the contributions of 'finance, insurance, real estate and business service' to GDP and employment was estimated to be around 13 per cent and 9 per cent respectively. In terms of numbers employed, this sector provides about four to five thousand jobs. In 1975, 13 per cent were held by expatriates.

Economic Dependence

In discussing the external dimensions of an economy, the terms 'openness' and 'dependence' are sometimes used interchangeably, though they connote fundamentally different things in practice. 'Openness' is commonly used to describe a situation in which a relatively high proportion of national income is generated by external transactions. 'Dependence' on the other hand refers to a complexity of factors arising from locus of decision-making with respect to the volume, quality and pace of economic activity; the pattern of production and consumption; the nature and direction of foreign trade, the adequacy of physical and financial resources etc. These factors can be reinforced by the structure and orientation of national institutions and the content of public policy.[25] It is possible, therefore, for a country to be 'open' and yet not be 'dependent' or to use the more significant term, 'structurally dependent'.[26]

While economic and financial policies can play an important part in influencing the way an economy functions, size and resource constraints tend to be important determinants of the degree of openness. The Bahamas is both an open and a dependent economy in an extreme sense. As indicated earlier, about three quarters of the country's GNP is derived from one activity, tourism, receipts from which can be even more volatile than income from an export crop, given the nature of the industry. For while in the latter case, the volume of production can ordinarily be varied, being subject to national control, and receipts can be stabilised within commodity and ad hoc trading arrangements of various kinds, tourism is an activity not amenable to this kind of quantity and price manipulation by virtue of the highly personalised character of the decisions involved in the process.[27] Generally, tourists decide where they go and how much they spend, and the fact that the Bahamas is not the only supplier of the 'product' sought puts a limit on the extent to which it can raise its price without losing its customers to competing resorts. To use familiar jargon, it is not in a monopoly position which would have allowed her to make fuller use of price variation technique in trying to maximise revenue. The fact that about 80 per cent of its visitors originate in one market, serves further to underline the economic dependence of the country.

A look at Table 1.13 shows that visible exports (excluding refined petroleum products which are based wholly on imported crude, and are shipped mainly to the United States and Puerto Rico) form less than 20 per cent of GNP. The major items of domestic produce, besides the few manufactured products discussed earlier, consist essentially of agricultural and marine goods sold in the nearby U.S. market which, as can be seen in Table 1.14, is the largest single outlet for the country's exports, taking over 60 per cent of non-oil products sold abroad in 1976. Exports of goods and non-factor services account on average for over 70 per cent of GNP.

In terms of the supply of foreign goods and (non-factor) services, the latter average about 15 to 20 per cent of GNP. Net factor payments abroad, as seen earlier, take about a fifth of the GDP. A glance at Table 1.13 shows that the import coefficient (i.e. the ratio of imports to GNP) fluctuates from year to year, but seems to average around 50 to 60 per cent. Imports of goods and services taken together amount to about 60 to 70 of GNP. As far as the suppliers of foreign goods are concerned, these comprise a very narrow group of countries, the U.S. alone providing about 70 per cent of the country's non-oil import requirements. In 1976 the U.S., the U.K., Canada and the EEC accounted for over 90 per cent of the non-oil supplies, and this appears to be the general pattern. As far as the composition of the country's imports is concerned, Table 1.15 shows that this covers a very wide range, the country being able to produce a very small proportion of its total requirements, a large part of which is closely related to the tourist trade on which the economy is mainly based. Of the $279 million non-oil products imported in 1976, food accounted for 25 per cent, manufactured goods (S.I.T.C 5+6+8) for 50 per cent, and machinery and transport for 17 per cent. Despite the obvious importance of imports to the Bahamian economy, it is worth pointing out that the country's insignificant position in world trade means that it is in no position to exert any influence on international pricing or supply behaviour in competitive markets.

Dependence of the Bahamian economy on the external world manifests itself in two other very prominent forms, one of which we have already drawn attention to earlier in our discussion. This is the large role assigned to private foreign capital in the development process. No reliable official data exist on the annual flow of external investment or the stock of capital owned by non-nationals. Rough unofficial estimates relating to direct investment have been put at around $1.5 to 2 billion dollars. The American component at the end of 1977 was given as $1.2 billion, of which $778 million was in finance and insurance.[28] Accepting the $2 billion figure for all countries this would amount to more than twice the 1977 GNP estimate. In terms of the ratio to population, this works out to around $9,000 foreign investment per head of population.

TABLE 1.13

IMPORTS, EXPORTS AND TOURISM RECEIPTS AS A PERCENTAGE (%) OF GNP, 1969 TO 1977
(Current Values)

$m.

Year	(1) GNP at Market Prices	(2) Goods, Imports[a]	(3) (2) as a % of (1)	(4) Goods, Exports[b]	(5) (4) as a % of (1)	(6) Tourism Receipts	(7) (6) as a % of (1)
1969	399.9	202.3	50.6	53.8	13.4	235.1	58.8
1970	400.5	177.6	44.3	57.6	14.4	230.1	57.4
1971	409.7	240.8	58.8	41.3	10.0	274.8	67.1
1972	414.5	248.0	59.8	70.2	16.9	280.9	67.8
1973	513.8	320.0	62.2	68.6	13.3	302.0	58.8
1974	605.7	360.0	59.4	82.0	13.5	323.8	53.4
1975	630.0	290.0	46.0	57.7	9.1	312.7	49.6
1976	700.0	336.6	48.0	76.0	10.8	363.1	51.8
1977[c]	750.0	271.7	36.2	86.8	11.5	407.2	54.3

a: Where possible figures have been adjusted to exclude conditionally duty-free imports entered at Freeport. The figures also exclude oil imports except for an estimate for domestic consumption.

b: The 1969 and 1970 figures include a small amount of re-exported goods. Oil has been excluded from these figures.

c: Provisional.

Source: Table 1.4 Central Bank of the Bahamas, *Quarterly Review*, various issues.

TABLE 1.14

THE BAHAMAS' MAJOR TRADING PARTNERS, 1969 AND 1976

Countries	NON-OIL IMPORTS				NON-OIL EXPORTS[a]			
	1969		1976		1969		1976	
	$m.	%	$m.	%	$m.	%	$m	%
U.S.A.	202.5	70.4	198.2	71.1	32.6	60.6	69.2	51.4
U.K.	25.8	9.0	41.9	15.0	11.8	21.9	5.8	4.3
Canada	13.5	4.7	8.0	2.9	1.9	3.5	8.7	6.5
Other EEC[b]	31.9	11.1	13.8	4.9	2.4	4.5	22.5	16.7
Other Countries	13.9	4.8	16.9	6.1	5.1	9.5	28.4	21.1
All Countries	287.6[c]	100.0	278.8	100.0	53.8	100.0	134.6	100.0

a: Includes re-exports of an unknown amount in 1969 and $58 million in 1976.

b: Original six.

c: Includes $100 million conditionally duty-free imports entered at Freeport.

Sources: Central Bank of the Bahamas, *Quarterly Review,* various issues, Department Statistics, *Statistical Abstract,* 1970

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TABLE 1.15

STRUCTURE OF FOREIGN TRADE BY SITC SECTIONS, 1969 AND 1976

S.I.T.C. Sections	Composition of Imports				Composition of Domestic Exports			
	1969		1976		1969		1976	
	$m.	%	$m.	%	$m.	%	$m.	%
0. Food and Live Animals	48.2	15.9	69.9	2.4	2.3	4.2	6.0	0.6
1. Beverages & Tobacco	13.6	4.5	12.5	0.4	3.7	6.8	10.3	1.1
2. Crude Materials, Inedible except Fuels	8.9	2.9	6.0	0.2	6.3	11.6	13.7	1.5
3. Mineral Fuels & Related Materials	14.7	4.9	2,613.7	90.3	0.5	0.9	849.7	91.8
4. Animal & Vegetable Oils & Fats	0.2	0.0	0.9	0.0	0.2	0.4	—	—
5. Chemicals	16.8	5.6	56.3	1.9	10.7	19.7	38.7	4.2
6. Mfgd. Goods Classified Chiefly by Material	57.3	19.0	46.9	1.6	8.2	15.2	7.4	0.8
7. Machinery & Transport Equipment	66.1	21.9	48.8	1.7	15.5	28.5	0.0	0.0
8. Misc. Manufactured Articles	73.5	24.3	37.4	1.3	5.6	10.3	0.0	0.0
9. Misc. Transactions	3.0	1.0	0.2	0.0	1.3	2.4	—	—
All Sections	302.3	100.0	2,892.6	100.0	54.3[a]	100.0	925.8	100.0

a: Includes a small amount of re-exports.

Sources: Department of Statistics Central Bank of the Bahamas, *Quarterly Review,* Dec., 1978.

The second form of dependence referred to is in the area of skilled and semi-skilled manpower requirements necessary for the functioning of the economic system which has emerged over the last two decades. The fact that the Bahamas still has to rely, to a significant extent, on foreign personnel in a wide range of capacities amidst a growing pool of unemployed labour, demonstrates the lack of attention that has been paid to the whole question of training and education over the years. Even today, despite the substantially increased budget allocated to the Ministry of Education, a carefully formulated programme linked to a practical training policy, and designed to meet the specific needs of the economy and the society and, thus, remove the over-dependence on foreign skills is yet to emerge. The mere refusal to grant work permits to foreign personnel will not automatically solve the more fundamental problem inherent in the quality and type of the education and training available to Bahamians. In fact it poses the serious danger of a mediocrity being developed that could do great harm to the country's reputation and to the efficiency aspect of its major economic activities.

Some Current Problems and Issues

In recent years, the economy of the Bahamas has been experiencing severe difficulties. Between 1969 and 1977, GNP in nominal terms is estimated to have grown at a rate of 8.1 per cent. Over the same period the average rate of inflation was about 7 per cent. In real terms, therefore, the economy hardly grew. Employment, too, has also declined. From a situation of full or near full employment in the late 1960s the unemployment rate increased to 9 per cent in 1973 and to over 20 per cent in 1975, the greatest concentration being among the primary and secondary level educated who accounted for 90 per cent of the total unemployed labour force in the latter year.

Following the period of rapid growth attained in the 1960s, and given the high level of expectations generated by the extraordinary economic expansion, this situation was bound to give rise to concern. In May of 1974, on the basis of a motion moved by a member of the ruling party in the House of Assembly, a Select Committee was appointed "to consider the social, cultural and economic plight of the Bahamian people". The Committee estimated that with an average of 1,800 young people leaving school per year, at least 10,000 jobs were needed at the middle of 1974. A labour force survey[29] published in 1976 revealed that with 18,000 people unemployed in 1975, this requirement has been grossly underestimated. It is often argued that there are jobs available, both in the private and public sectors, in which Bahamians show no interest. While the figures often quoted tend to be exaggerated, it is a valid contention that Bahamians are not willing to do certain types of work. During the 1950s and 1960s when the economy expanded at a rate which was not only able to accommodate the local work force, but a great many foreigners as well, Bahamians were able to be very selective in the choice of jobs. A pattern developed in which the bulk of the menial and lesser paying work was done by the

Haitians and, to some extent, by Jamaicans and Turks Islanders, (many of whom, like the Haitians, were illegal immigrants) at wage rates below what the average Bahamian would accept. In government's drive to repatriate illegal residents, a number of vacancies have thus been created. Bahamians, however, are not willing to do what they contemptuously refer to as 'Haitian' work, particularly at the wage levels at which the Haitians were being paid.

There has been much speculation about the causes responsible for the downturn in the level of economic activities. Some observers attribute it to the policies of the ruling Progressive Liberal Party (PLP) which took power in 1967 from the merchant class-dominated United Bahamian Party (UBP). Others hold the view that the prevailing social and economic conditions stem directly from the bouts of recession which the United States economy has experienced since the early 1970s and particularly since the oil crisis of 1973. It is argued that these downturns have affected both the flow of tourists and investment on which the Bahamian economy is heavily dependent.

These views appear to arise out of an awareness of the structural characteristics and functioning of the economy on the one hand and of a conviction on the other hand, that a return to the policy framework of the '50s and '60s could provide the necessary stimuli for social and economic advancement. Whatever degree of validity these observations contain, if accepted uncritically, they can easily lead to simplistic and ad hoc solutions and approaches which could not only increase the vulnerability of the economy to external forces, but even undermine certain national objectives which are deemed basic to the exercise of forging an increasingly self-reliant nation. It is important in this situation to distinguish between short term needs and longer term goals.

In recent years economists have tended to make a strong distinction between economic growth and economic development in the formulation of national policies. It is recognised that it is possible for an economy to grow without any significant improvement to the material welfare of the broad masses of the local population or qualitative changes in the structure and functioning of the economy. Economic development is seen as the emergence of a situation which not only encourages growth, but permits an equitable distribution of the benefits stemming from that growth in terms of income, employment etc. It is also seen as a process of the structural transformation of the economy in terms of its ability to develop and sustain a desirable standard of living. The latter implies a complex of changes with respect to sectoral relationships, the structure of production, ownership and use of resources etc., and, therefore, calls for a consistent set of policies and measures which could influence and move the economy in certain approved directions.

In order to put the present difficulties facing the Bahamian economy and the responses to these difficulties in perspective, it is necessary to have an insight into both the basis and nature of the country's post-war growth, and the policy framework associated with it. As we have indicated earlier, tourism (including associated activities like construction and land development) and to a lesser extent financial activities were the main instigators of growth during the 1960s. Almost all the capital came from abroad. During the '50s and '60s the Bahamas was largely virgin territory, and the closing of the Cuban facilities in the early '60s boosted a trend that had already begun and opened opportunities which foreign investors and speculators were quick to grasp. In the laissez-faire atmosphere that prevailed some people benefited immeasurably. The country lived for the moment and this was apparent from the fact that there was no conscious attempt to use a favourable set of circumstances to put the economy on a firm basis by establishing a proper framework for the exploitation of its resources, or eventually getting the development dynamic under local control. This would have seemed necessary since, even then, amidst the apparent prosperity, there was a deep and growing dissatisfaction over the distribution of benefits and prevailing social conditions.[30]

By the late 1960s, the boom had begun to taper off and the effects were exacerbated by the frequent depressions which the U.S. economy began to suffer from the early '70s. The element of uncertainty, introduced by the change of government in 1967 (in fact it was more than that; it was the end of a political era), is believed by some observers to have had a severe impact on investors' confidence and, hence, on the level of economic activity. Two particular decisions associated with this argument are: (i) the decision by the new government to reassume direct responsibility for immigration matters in the Freeport area, which was ceded to a private organisation under an agreement made in 1955; and (ii) the Government's Bahamianisation programme which was intended to encourage greater employment of Bahamians through the use of the work permit instrument.

These decisions were made, not on the basis of any political ideology or economic philosophy, but from a conviction that they would lead to a greater involvement of Bahamians in the economy. Given, however, the limited availability of local skills (which was related in no uncertain way to the long existence of an inadequate education system), and the reported over-stringent application of the work permit policy, this may have had some effect on the flow of investment. The same could probably be said about the failure to articulate a clear policy towards the Freeport project in the light of the doubts raised by the decision to amend the immigration clause in the Hawksbill Creek Agreement. The argument put forward by critics was that if one section of the Agreement could be altered there was no reason why the others could not, particularly in the absence of assurances that the Agreement would be upheld. The fact of the matter, however, was that Freeport, as originally conceived, was designed to be virtually a state within a state and no government conscious of its integrity and responsibility could easily allow control over immigration in any part of its territory to be left entirely in private hands.

Given the continuation of the liberal policies pursued in other spheres one could only speculate about the impact of these two decisions. The more fundamental question to be posed is, could the growth achieved during the '60s have gone on forever given: (i) the revenue resources of the country and (ii) the nature of the development that has taken place. With respect to the first question, one observes that even with a limited revenue base government has sole responsibility for maintaining and developing the physical infrastructure of the country. The larger the number of visitors, the greater the pressure on these facilities and, hence, the greater the need for government expenditure in this area. The tourist trade is a highly competitive one and a neglected and deteriorating amenity system is bound to have adverse repercussions on it. It is difficult, therefore, to aim at attracting increasingly larger numbers of people without being prepared to devote a substantial proportion of the capital budget to the infrastructural facilities. One could argue that a greater inflow of tourists would generate increased income and this would offset part of the costs. In a situation where the revenue base is limited (as we shall see later the structure of the tax system is not particularly income elastic), this contention is not very strong. For it to hold, there would have to be a radical change in the tax base; a step for which the country has not been prepared and is still not willing to take. The fact that infrastructural requirements have to compete with other social demands have placed heavy pressures on Government's limited revenue position. The increased resort to public borrowing during the 1970s cannot be seen in isolation from government's objectives, policies and the tax framework of the country.

With respect to the second question relating to the nature of the development that has taken place, we alluded to the fact that while financial activities stemming from the tax haven status of the country make a contribution to the economy, the real basis of postwar expansion has rested heavily on activities related to the tourist industry. These include particularly the construction and operation of accommodation, entertainment and other servicing facilities and land development. Even if one chose to ignore the social and cultural impact of a large influx of tourists on a small population, from a strictly economic point of view, there would appear to be some optimum size a tourist industry can assume at any point in time and within a given set of parameters. In the long term the most important limiting factor would be the resources at the disposal of the country, perhaps the most critical of these being the land supply, on which there tends to be competing demands and which has great social value.

Besides the resource question, there are other considerations which affect the state of tourism and related activities at any moment. These are generally outside the control of the host country. The expansion of the hotel sector, for example, depends to a critical extent on the level of existing hotel room occupancy, and while local costs can have an effect on the latter, the more important factors tend to be the growth of income in, and the state of the economy of countries of tourists residence, the relative attractiveness of other resorts, the costs of transport, etc. For these reasons, construction booms, particularly, tend to come in spurts, and it is difficult to conceive of a situation where this type of activity can be kept at a perpetually high level. Once the high point is reached, and this could be dictated by both policy and resources, even the spurts may become more occasional and of smaller durations. Where foreign capital is the major element in the construction process, the flow of investment would be affected by a wider range of concerns than just the availability of money-making opportunities, and of course, this makes the situation even more unpredictable. Depending on the perception of the importance of foreign capital to the economy, this could further dicate the whole tone of government's policy and action.

The experience of the Bahamas over the greater part of the '70s has been affected, not only by the nature of the activities which formed the basis of the '60s boom, but by the policy framework within which the whole growth process has taken place. To this question we now turn our attention.

International travel is not a new phenomenon on the world scene. The growth of personal incomes in the postwar period, however, has not only resulted in tourism becoming one of the fastest growing industries in the world, but also the largest single item in foreign trade. For example, while world exports could only increase by 7½ per cent annually between 1950 and 1970, receipts from international tourism (excluding payments for international transportation) was able to grow at an average annual rate of 11 per cent over the same period. As a proportion of world exports, tourist receipts are estimated to have increased from 3.4 per cent in 1950 to 5.6 per cent in 1970. Since then, although the proportion has hovered around 4 to 5 per cent, the number of tourists and the money spend by them has continued to increase, reaching figures of 244 million for arrivals and over U.S. $60 billion for expenditure (excluding international fare payments) in 1978.[31]

These statistics look very impressive indeed. And there is no doubt that the growth of tourism in the postwar period has brought a measure of prosperity to several countries, both in the developed and developing world. The fact remains, however, that because of the structure, organisation and orientation of the industry in most developing countries, gross receipts figures greatly exaggerate the real benefits to the national economies. This is no better illustrated than in the Bahamas where the traditionally high foreign ownership pattern enmeshed with a web of international structures relating to all aspects of the industry, and the almost total dependence on external sources for food, materials and equipment, made tourism, and, to a significant extent still makes it largely an 'offshore' activity in which Bahamians play little more than a peripheral role. No serious study has even been undertaken with a view to ascertaining the precise financial benefits accruing to the Bahamas, after all out-flows are taken into account. Rough estimates of the 'multiplier' which measures the final impact on total income from any given amount of expenditure after leakages in the form of savings and imports are taken into account has, not surprisingly, been put at the modest figure of 1.36,[32] even when the most generous assumptions were made. When first round import leakages were taken into account the 'true' multiplier was calculated to be 0.894. See the Checci Report, Appendix B3.

The growth of tourism in the Bahamas has largely been an unplanned affair, government's efforts (until recent years) hardly extending beyond providing and maintaining certain basic infrastructures within its limited financial capacity, and external promotion. As in most resorts the world over and particularly here in the Caribbean, the tendency has been to push 'development' i.e. to get more tourists and to increase expenditure per tourist.[33] The result has been that while numbers have certainly grown as shown earlier, the 'economic, social and cultural' problems have become increasingly more intense, leading to the present serious concern in many quarters.

Given the natural assets of the Bahamas, there is no doubt tourism can play an important part in the material progress of the nation. Particular attention, however, will have to be paid to the questions of increasing domestic production and instituting policies designed to get nationals more involved in the ownership and operation of plants and facilities.

While the PLP Government has, since 1967, placed great emphasis on the employment of Bahamians in an effort to redress some of the injustices and social anomalies perpetrated in previous years, one could detect initially, even within this policy, a tacit acceptance that foreign ownership of the means of production was somehow inveitable, and that private foreign capital was the crucial element in the development effort. This perception no doubt had its origin in the development experience of the last two or three decades, in which external initiative and fianance played no small part. In recent years the ambivalence in this area of policy has fast been disappearing, and government itself has taken ownership of a number of major hotels and is in the process of constructing others. It has also now taken the long needed step of clearly defining the areas from which foreign enterprise would be excluded, thus removing a large degree of uncertainty.[34] One might add that equally necessary, if advantage is to be taken of this decision, is the need for complementary action aimed at overcoming critical historical handicaps stifling local enterprise.

Since there is a very vocal school of thought which sees foreign capital as the panacea for all the ills facing the Bahamas, a further word needs to be said on this issue. Many developing countries which are unable to generate a sufficient level of domestic savings find it necessary to seek foreign resources in order to accelerate the pace of their development. Development for these countries not only means strengthening their economic fabric, but becoming more self reliant. In other words, a major aim is to decrease their external economic dependence.

Given these objectives, recipient countries tend to be very careful about the terms on which they receive foreign assistance and about the areas in which foreign capital would be tolerated. It is recognised that far from increasing development or reducing dependence the indiscriminate flow of external savings can effectively frustrate these objectives. New foreign investment may assist in alleviating some short term problems, but exerts a price in the form of subsequent outflows, often without making any fundamental contribution to domestic development.[35] One writer makes the point very eloquently when he says that a "regime of unrestricted foreign private investment is self-perpetuating and breeds continuing and growing dependence on the external world. In the end, the very functioning of the economy becomes dependent on taking the drug of foreign private investment in ever increasing doses".[36] Perhaps one of the most important effects of foreign investment, particularly in small societies, is its potential for stunting the growth of local enterprise and initiative, and this too, can perpetuate and deepen a state of dependence.

The various aspects of the tourist industry do not involve any complex technology for their operation. In many areas the capital investment required is not large. What is needed is the creation of a framework which would not only motivate Bahamians, but provide the mechanisms for greater involvement and participation. In this connection, adequate and relevant training programmes are highly essential.

Measures are also needed to increase the savings effort and to make finance more accessible to Bahamians who do not qualify by some of the traditional criteria used by financial institutions. Technical assistance, as indicated earlier, is also a prerequisite, not only in the agricultural field, but in the small industry sector. The latter which apparently is not reserved for Bahamians, has enormous potential in terms of its linkage possibilities to tourism.

One of the main rationale for greater local control and ownership lies in the fact that profits generated would tend to be kept in the country and be reinvested, thereby creating greater income and employment opportunities. Another advantage of localisation is that it reduces in the long run the foreign exchange leakage associated with foreign investment. Initially, the external reserves of a country will be increased through the injection of foreign capital, but the subsequent stream of outflow (or even the eventual liquidation of the investment) may far exceed the initial inflow. Another possible (though less obvious) leakage arises from the practice of selling out the country's land patrimony to foreigners in pursuit of some very short term and, in some cases, very illogical objectives.[37] The sale of locally owned property to foreigners, the rationale runs, brings in foreign currency upon immediate purchase, and in the event that a winter or holiday home is constructed further spending takes place, with seasonal visits giving rise to additional contributions.

Though some employment may be generated from construction activities, it is clear that this kind of tourism has little to contribute to local development. In fact it can have serious repercussions on the expansion of the industry by diverting to housing purposes, lands ideally located for hotel sites, or suitable for agriculture. More immediately, property purchased by foreigners is held for speculation and later resold to residents at prices incorporating a capital gain element, therefore imposing a foreign exchange cost on the country when the proceeds are repatriated.

Another disadvantage resulting from foreign bidding for local real estate is the added pressure placed on property prices which nationals may find increasingly difficult to meet, thus aggravating an already serious social problem. The emergence of foreign enclaves with their conspicuous life styles, and the retreat by the local population to less attractive home sites, in view of their inability to compete for choice areas, is bound to breed resentment and hatred toward the visitor and foreign resident, particularly at times when social conditions are deteriorating.

Another non-pecuniary effect of the visitor industry is the tendency of the local population to imitate the spending habits of the tourists, thus reducing the propensity to save and hence intensifying the capital constraint in the development process.

Concluding Observations on the Economy

From time to time official concern has made it necessary to examine certain macro aspects of the tourist industry, such as employment, profitability, the quality of facilities, etc. with a view to instituting measures which could have a favourable effect on these various spheres.[38] No serious thought so far, however, appears to have been directed towards determining whether there is some manageable limit to the size (or the scale) of the tourist industry which the social fabric of the country is capable of tolerating without complete disintegration or deculturisation.

In this connection, it is worth noting that there are certain resorts[39] which have found it necessary to programme the growth of their industry in relation to both economic and social needs, and are thus able to formulate policies within a definite frame of reference. The periodic spurts associated with tourism and the consequent high level of activity generated ought not to detract from the need for a broad consensus on the industry with respect to its role, scope, potential, the tolerable limits of its social effects and its relation to other economic sectors and activities. It is only in this perspective that a consistent set of policies can be formulated.

The Political Setting

Amidst grave doubts in certain quarters about its ability to survive economically or to retain sovereign control over its affairs, the Bahamas attained its constitutional independence on July 10, 1973, and shortly, thereafter, became the 135th nation of the United Nations and a member of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD) respectively. The event marked the end of more than 300 years of British colonial rule. The country, in fact had been self-governing since 1964, when the constitutional changes of that year replaced a set of legislative arrangements that had been observed with minor alterations since 1729. While the Independence Constitution has naturally increased the powers of Government, the system is essentially that prevailing before July 10, 1973, in which there were two chambers: a Senate consisting of 16 members, the majority of whom are appointed by the Governor "on the advice of the Prime Minister" and a House of Assembly consisting of 38 elected members. (Provision is, however, made for increasing membership and creating new constituencies).

The politics of the country over the last two decades have been dominated by two political parties: the Progressive Liberal Party (PLP) formed in the early '50s and deriving its support mainly from the black community which comprise some 80 per cent of the population; and the United Bahamian Party (UBP) which was put together shortly after the 1956 general election by the white Bay Street merchants (often referred to as the 'Bay Street Boys') who were returned to power by virtue of their victory in the election in which the PLP gained only six of the 29 seats. Despite its narrow base and a history of racist policies, the UBP was again to repeat its win in the 1962 general election in which women voted for the first time. Though various reasons have been advanced to explain this result, it is clear that the unjust electoral system was an important factor as can be seen from the fact that the UBP with only 36.6 per cent of the votes won 19 of the 33 House Seats, while the PLP with 44 per cent of the votes could only muster a total of eight seats, the remainder going to independents and a representative of a third organisation.

This situation was not destined to last and in 1967, amidst a barrage of charges of corruption and discrimination against the ruling oligarchy, the PLP, under Lynden Pindling, emerged with 18 of the 38 seats contested, with an equal number going to the UBP and the remaining two to an independent and a member of the Labour Party respectively. The decision by the latter to support the PLP and the acceptance of the Speaker's post by the independent, an antagonised UBP member, combined to put a black party in power for the first time.

The increasing support attracted by the new government was demonstrated a little over one year after its accession to office when in the general election of 1968, which was precipitated by the death of one of its representatives, the PLP won 29 of the 38 seats in the House, with only seven going to the UBP — a result that was to be repeated in the 1972 elections in which the main opposition Party turned out to be not the UBP, but the Free National Movement (FNM) which was created from a merger of remnant UBPs and a breakaway faction of the PLP, known as the Free-PLP. In 1976 the FNM split into two groups (the Free National Movement and the Bahamian Democratic Party) both of which lost to the PLP in the 1977 general elections.

Given the 'refugee' nature of a great deal of the capital invested or held in the Bahamas as a result of its tax haven status, elections and changes in government tend to be watched with close concern by the financial and expatriate community. Although all major political parties in the Bahamas are firmly committed to preserving the traditional sanctuary climate of the country, this has not prevented the occasional outward large movement of funds, or the curtailment of inflows stemming from a fear of a change in policy. In order to honour its commitments, therefore, and thus preserve its 'solvency' image, the monetary authority has to be prepared for such eventualities at any time, and particularly so it seems in periods approaching elections when rumours regarding taxation and nationalisation gather their greatest strength.

Although the period of UBP rule, between the mid-'50s and 1967, was one of unmatched prosperity, it is true to say that the bulk of the wealth generated accrued largely to foreigners and a local clique who had the advantage of dominating the parliamentary machinery, while being deeply involved in private business at the same time. Even in the area of social expenditure such as education, health and housing, there tended to be a large element of discrimination, resulting in a deep inequity in the social system, which is still very much in evidence today, despite a determined (if inadequate) effort by the present administration to correct the situation.

FOOTNOTES

1. Pronounced 'key', this word, which is of Arawak origin, means a small island.
2. Michael Craton, *A History of the Bahamas,* London, Collins, 1969, pp. 11–12.
3. This can be seen to some extent in the following table which shows expenditures[a] in certain countries of the region by U.S. visitors over the 1960-1977 period.

U.S.$m.

Countries	**1960**	**1965**	**1970**	**1975**	**1977**
Mexico Border Zone	245	355	463	1,047	1,165
Other Mexico	120	185	315	590	753
South America	45	68	90	242	254
Bermuda	28	35	63	118	123
Bahamas	42	62	127	161	158
Jamaica	28	52	95	118	100
Other Br. W. Indies	18	22	44	103	144
Netherlands W. Indies	10	14	18	97	106
Other W. Indies and Central America	n.a.	35	43	190	159

a: These include spending in foreign countries for food, lodging, entertainment, transportation purchased abroad, and other expenses incidental to a foreign visit.

Source: U.S. Department of Commerce, *Survey of Current Business,* various issues.

4. This figure clearly does not include the vast majority of illegal Haitian immigrants of whom it was estimated there were some 25,000 in 1970 (40,000 in 1974). These figures, however, have probably been considerably reduced in the wake of government's repatriation drive. See paper by Dawn Marshall presented at the first Caribbean Studies Association conference held in Puerto Rico in January of 1975.
5. See *Population Projections for Bahamas until 1980,* Department of Statistics, Nassau.
6. See *World Bank Atlas,* 1978.
7. In nominal terms per capita GNP is estimated to have grown by 3.4 per cent between 1960 and 1970. The rate for the period 1965-1972 has been put at 0.6 per cent.See *World Bank Atlas,* various issues.
8. See *Population Projections, op. cit.*
9. Interim Report of the Select Committee appointed by the House of Assembly on the 30 May, 1974, to consider "the social, cultural and economic plight of the Bahamian people".
10. Checci & Co., *A Plan for Managing the Growth of Tourism in the Commonwealth of the Bahama Islands,* Washington D.C., August, 1969 , p. 83.
11. IBRD, *Current Economic Position and Prospects of the Bahamas,,* Washington, April, 1974 p.14.
12. Under the existing Act, promotors of new hotels are exempted from all taxes on hotel earnings for twenty years and from real property taxes. They are also entitled to claim a refund of customs and other import duties levied on materials and furnishings imported for purposes of constructing and equipping hotels. To qualify for these exemptions, a hotel must possess a minimum of 50 rooms in Nassau, New Providence, and 20 rooms in the Out Islands.
13. For further details see, *A Guide to Industrial Opportunities in the Commonwealth* of the Bahama Islands, Ministry of Development.
14. At the end of 1971, there were almost 14,000 companies (696 classified as manufacturing) registered in the Bahamas. The bulk of these, however, were related to 'offshore' activities.

15. It is reported that Panama is in the course of constructing an oil terminal on the Pacific Coast to trans-ship Alaskan oil through the Canal to ports on the U.S. east coast. Another development is the proposed Louisiana Offshore Port which will make it possible for super tankers too large for U.S. ports to offload directly into storage facilities ashore. (See *Financial Times Survey* of 10 July, 1978).

16. Department of Statistics, *The Labour Force Report,* 1975.

17. For an enlightening discussion of Hong Kong's early postwar development, see Edward Szczepanik, *The Economic Growth of Hong Kong,* London, Oxford University Press, 1958 .

18. See *Report of the Royal Commission Appointed on the Recommendation of the Bahamas Government to Review the Hawksbill Creek Agreement,* H.M.S.O., 1971.

19. The power to grant permission to operate in Freeport was implicitly vested in the Port Authority which employs a licensing system involving payment of fees by approved concerns. Until 1970, when the government amended the Hawksbill Creek Agreement, licensees were virtually able to function without any reference to the governmental authorities, and with no restrictions on the use of foreign personnel.

20. In more recent years total visitors have been averaging between 300,000 to 400,000.

21. It should be noted, however, that the plantation system of agriculture that is so prevalent in some of the other islands of the Caribbean never took root in the Bahamas. The early attempts by the Loyalists (who fled the United States after the American Revolution) in the late eighteenth and early nineteenth century to introduce cotton growing on a large scale met with dismal failure, the major causes being the unsuitable soil conditions and pests.

22. This situation is reflected very clearly in the figures for 1970 and 1975, which show the per capita personal income (employed labour force) for the various sectors as follows:

Sectors	**Per Capita Income ($'000)** 1970	1975
Agriculture, Hunting, Forestry and Fishing	1.78	2.88
Mining and Quarrying	6.06	11.50
Manufacturing	4.56	8.25
Electricity, Gas & Water	5.01	4.08
Construction	4.91	4.75
Wholesale & Retail Trade, Restaurants & Hotels	3.83	3.50
Transport, Storage & Communication	5.04	5.99
Financing, Insurance, Real Estate & Business Services	7.76	6.12
Community, Social & Personal Services	3.91	4.24
Average Per Employed Population	4.36	4.74

Sources: Census Monograph No. I, *Manpower and Income* and *Household Income in the Bahamas 1975,* Department of Statistics.

23. "For many years past, agricultural developments in the Bahamas have been minimal. The Government is determined that this shall change . . . ." (Para. 115, *Independence White Paper, 1962).*

24. "In addition to bringing about a substantial up-turn in agricultural productivity, it is the Government's intention to improve the means of marketing foodstuffs. Using the guidance of the Food and Agriculture Organisation, or a similar organisation to augment our own capabilities, a new marketing system is to be implemented which takes account of quality control, the establishment of grades and standards, price stabilisation, storage and handling facilities and a reliable two way flow of marketing information.

The Government's policy incorporates a concerted effort to improve the circumstances of the small farmer, to encourage others to return to the soil and a programme to encourage consumers to 'buy Bahamian'. . . ." (Paras. 116 and 117, *White Paper, op. cit.).*

25. Havelock Brewster emphasises the functioning of the economy. He defines economic dependence as "a lack of capacity to manipulate the operative elements of an economic system. Such a situation is characterised by an absence of interdependence between the economic functions of a system. This lack of interdependence implies that the system has no internal dynamic

which could enable it to function as an independent autonomous entity". See his "Economic Dependence: A Quantitative Interpretation" in Norman Girvan (ed.), *Dependence and Under-development in the New World and the Old.* Special Issue of Social and Economic Studies, March, 1973.

26. The case of the United Kingdom is often used to make this point. See M.A. Odle, *The Evolution of Public Expenditure (The Case of a Structurally Dependent Economy: Guyana)*(Institute of Social and Economic Research, U.W.I., 1976). p.1.

27. On the other hand, it can be argued (as some observers do) that since it is easier for foreign governments to impose restrictions on other countries' goods entering their markets than it is for them to prevent their citizens from travelling to a particular country or countries, tourism in this context represents a more reliable source of foreign exchange. A further argument often advanced to support this contention stems from the observation that it is often less difficult to develop new tourist markets than it is to find new buyers for many primary commodities on which developing countries tend to depend.

28. U.S. Department of Commerce, *Survey of Current Business,* August, 1978.

29. Department of Statistics, *The Labour Force Report,* 1975.

30. See Doris L. Johnson, *The Quiet Revolution in the Bahamas,* Nassau,Family Islands Press Ltd., 1972., Chapter 3, passim.

31. For a detailed description of the growth of world tourism see Michael Peters, *International Tourism, The Economics and Development of the International Tourist Trade,* (London, Hutchinson & Co., (Publishers) Ltd., 1969). Some of the more recent figures used here, however, are taken from the publications of the World Travel Organisation (formerly IUOTO).

32. Checci & Company, *op. cit.,* Appendix B-3.

33. Economic Planning Staff, 'Overseas Development Administration', *Project Data Handbook - Tourism,* London; Foreign and Commonwealth Office, 1972., p. 58. See also George Young, *Tourism, Blessing or Blight?* (Penguin, 1972), Ch. 7.

34. Fourteen areas have so far been reserved for Bahamian citizens. They are as follows:

    1. Wholesale and re-sale distribution up to $2 million in value;
    2. Commission agencies engaged in the import and export trade;
    3. Public transportation by land, sea and air, including: (a) taxis, self-drive cars, scooters and bicycles, buses; (b) inter-island passenger, freight mail; (c) inter-island air taxis or charterers;
    4. Newspaper and magazine publication, advertising and public relations;
    5. Interior decorating;
    6. Cinemas, theatres, nightclubs and restaurants (except gourmet ethnic restaurants);
    7. Security services;
    8. Handicraft;
    9. Construction, up to $2 million in value;
    10. Service establishments such as hairdressing, barbering, automotive and appliance repairs;
    11. Guest-houses and hotels of 25 rooms or less;
    12. Fishing,
    13. Farming up to 25 acres;
    14. With effect from 1 May, 1980, foreign real estate agents will not be given permission to sell or manage real estate in the Bahamas.

    Where foreign investment exists in the above areas, a transfer to local ownership will have to be effected within a mutually agreed time frame. The ceiling date is expected to be 1982.

35. For a good discussion on some of the costs and benefits of foreign investment, see A. McIntyre, and B. Watson, *Studies in Foreign Investment in the Commonwealth Caribbean,* No. 1, Trinidad and Tobago, (Institute of Social and Economic Research, U.W.I., 1970).

36. William Demas, quoted in *Caribbean Contact,* October, 1974.

37. It should be pointed out that it was only in late 1979 that a decision was taken to exercise greater control over the sale of land to foreigners.

38. One of the best known studies dealing with these subjects is the Dayton-Keenan Report done for the Ministry of Tourism in 1973.

39. Bermuda, for example, has gone some way in recognising the undesirable consequences of unplanned tourism growth and has taken certain steps to keep the industry within manageable proportions.

CHAPTER 2

THE COMMERCIAL BANKING SYSTEM OF THE BAHAMAS

Early History

Prior to 1835, no banks of any kind are known to have existed in the Bahamas. The first initiative towards the establishment of such institutions was taken in that year when the then government introduced legislation[1] for the setting up of a government savings bank (GSB) which came into being in 1836. Through a series of subsequent Acts, the scope of the GSB was gradually expanded to include commercial banking functions. In 1837 it was formally converted to the Public Bank of the Bahamas (PBB).

The PBB not only accepted deposits (on both demand and fixed accounts) but also made loans and is reported to have done a limited amount of discounting. The Bank had no capital and according to C.F. Gahan, (who carried out an official study of the affairs of the bank in 1885), "is supposed to have made its advances according to the extent of its deposits".[2] No commission was charged on current accounts and the only source of profits was "the differences of interest between the deposits and the loans, the bank for the former allowing 4 per cent and for the latter receiving 6 per cent in each case payable quarterly. . ."[3] The PBB functioned until 1886[4] in which year it folded up after the Government found itself having to borrow money in order to redeem the liabilities incurred by the bank in the course of operations.[5] While the immediate reasons for its failure were 'diagnosed' as "a general want of a system and discipline in the conduct of its affairs, the absence of a good system of bookeeping and the want of an efficient control in making its loans",[6] there is no doubt that the severe depression which hit the Bahamas following the end of the American Civil War played a crucial part in the demise of this institution.

Following the closure of the PBB it became evident that any initiative for the establishment of a second commercial bank in the Bahamas had to come from the private sector. In his report, Gahan had strongly recommended that government stay out of commercial banking activities, which he felt were better left to private enterprise. "The Government", he wrote, "should not involve itself in all the difficulties and liabilities that relate to a traffic with money and which only belong to the legitimate sphere and action of a Commercial Bank".[7]

For more than three years following the demise of the PBB, the country remained without the services of a commercial bank. It was not until June 3, 1889, when a joint stock (limited liability) company with a paid-up capital of £10,000 opened for business as the Bank of Nassau did the country get its second bank, but the first one privately owned. The company was, in fact, incorporated the previous year[8] by its promoters, among whom were a number of the country's prominent citizens[9] who had become convinced of the need for such an institution, notwithstanding the experience of the Bahamas' first bank and the general state of the economy at the time.

In the course of time the Bank of Nassau acquired a wide range of services which included the operation of current, savings and time accounts, the issuance of draft and cable transfers, the negotiation or collection of foreign drafts and bills of exchange, receiving and remitting money for firms and individuals doing business in the out-islands and collecting money from the government on behalf of clients for crediting to their accounts or transferring abroad.

The Bank of Nassau operated for a little less than three decades until 1917 when it, too, ran into difficulties[10] and was absorbed by the Royal Bank of Canada[11] which had established a branch in the colony in 1908. Between 1917 and 1946 Royal remained the only commercial banking institution in the Bahamas. In 1947 it was joined by Barclay's Bank D.C.O. (now Barclay's Bank International) and in 1950 by the E.D. Sassoon Banking Company[12] (now Charterhouse Japhet Bank and Trust International Limited). These were followed by the People's Penny Savings Bank (a locally owned firm dealing only in B$) in 1952 and the Bank of Nova Scotia in 1956. On the heels of these institutions came the Canadian Imperial Bank of Commerce, the Bank of Nassau[13] and the Mutual United Bank of the Bahamas (another locally owned bank)[14] in 1957. Following these were the Bank of London and Montreal[15] in 1958, First National City Bank (now Citibank) in 1959 and the Chase Manhattan in 1960. While seven others were set up during the '60s bringing the number of fifteen[16]in 1970. By the beginning of the '70s it had become clear that the process had come to a halt, at least as far as the scope for engaging in the domestic market was concerned. Though there have been a number of organisational changes (involving changes in ownership in some cases), since 1970 no new banks have been established with the object of conducting local business, reflecting the somewhat over-banked position the country has attained in recent years. At the end of 1978, in addition to the Penny Savings Bank (which still deals only in B$), there were 11 authorised dealers, 10 of which were active in the domestic retail market.

Administrative Framework

Before going on to discuss the structure of the banking system it might be useful at this point to say a brief word on the legal and administrative arrangements under which banks and trust companies operate in the Bahamas, and the main thrust of the existing banking legislation.

Before 1965 there were two pieces of legislation to which banking operations in the Bahamas were subject. One was the Companies Act of

TABLE 2.1

GROWTH OF COMMERCIAL BANKING INSTITUTIONS IN THE BAHAMAS, 1836 TO 1979

Year End	No. of Banks in Operation	No. of Offices[a]
1836	1	1
1887	–	–
1889	1	1
1908	2	2
1918	1	1
1946	1	1
1947	2	3
1950	2[b]	4
1952	3[c]	7
1958	8	20
1960	11	29
1966	16	51
1970	15	64
1976 (mid-year)	12	69
1979 (mid-year)	12	60

Note: The table excludes banks set up to deal exclusively in the external market, or to act purely as investment agencies of foreigners wishing to take advantage of the tax situation.

a. Includes one-office institutions, offices of the Penny Bank and the branches and sub-branches of the clearing banks.

b. Figure excludes the E.D. Sassoon Banking Company Limited which did not become an authorised dealer until 1960. (This bank has since undergone several changes of name and ownership.)

c. The People's Penny Savings Bank (which does not operate current accounts and deals only in Bahamian dollars) is included in this figure and those that follow.

Sources: Colonial Office Reports; *the Bahamas Handbook,* various issues; the Central Bank of the Bahamas.

1886 which has undergone slight modification over the years. The other was the Banks Act of 1909 which, despite two subsequent amendments (one in 1944 and the last in 1964) remained virtually the same as the original law, except for the elimination of the note issuing provisions which were originally inserted to provide a legal framework to the note issue function of the Bank of Nassau,[17] and of any other institution that might have been authorised to do so in the future. While the Act required banks doing business in the Bahamas to publish a yearly audited statement of their accounts[18] and empowered the Governor to call for further information (provided this did not involve revealing the private accounts of a client), this legislation could by no means be construed as a controlling law, given the narrow scope of its provisions and the limited objectives to which it addressed itself. Nevertheless, it served its purpose while the Bahamas remained attractive only to a few big international concerns which not only had a reputation to protect, but stood little chance of failing, given the enormous resources at their disposal. Once the smaller institutions started moving in, however, many of them getting into business for the first time, and some with no other motive than a quick buck, the whole situation changed drastically and the existing law proved highly inadequate for dealing with it.

The disappearance of a number of banks with clients' money and the failure of some others in the early '60s forced the government into acting and the Banks and Trust Companies Regulation Act of 1965 was the result. The Banks Act of 1909 was also amended to include a definition of 'banks' — an omission in the original legislation which permitted a wide range of enti ties to pose as such — and a section dealing with the preservation of secrecy.[19]

The Banks and Trust Companies Regulations Act, 1965, requires that any company wishing to carry on banking and/or trust business in the Bahamas, whether such company is incorporated in the Bahamas or not, must obtain a licence for the conduct of such operations. Licences issued by the Central Bank of the Bahamas which now administers the Act, fall broadly into two categories, 'public' (or unconditional) and 'restricted' (or conditional). The 'public' licence, as the name implies, allows the holder to carry on business with the general public, either within or outside the Bahamas. A 'restricted' licensee on the other hand, is prohibited from dealing with persons or entities other than those with whom or for whom it can conduct business as specified in its licence at the time of issue.

In view of the differences in operating scope implicit in these two types of licences and the nature of the transactions involved, the costs of procurement and capital requirements associated with each in terms of regulatory requirements also differ.[20] Besides the two main categories of licence mentioned, two other types are issued, viz., the non-active and the nominee trust. The former is often used in situations where the owners would like to incorporate a bank or turst for future, rather than immediate use, or to preserve a name to which they attach some degree of importance. The non-active licence can also be used as a transitional device to prevent an institution which goes into voluntary liquidation from doing further business, while at the same time retaining its obligations as a licensee. The trust nominee licence is an instrument used by institutions managing a large number of companies to avoid the cumbersome legal procedures which arise when the employees of these institutions (who are often used as shareholders, directors, etc. to satisfy certain legal requriements), leave their jobs for one reason or another.

Some indication of the growth of the various types of licences since 1967 is provided in Table 2.2. The number of banks and/or trusts holding a public licence increased from 90 in 1967 to 191 in 1973, declined over the next few years, but started to rise again since 1976. The number of 'restricted' institutions (excluding 'nominee trusts') grew from 97 in 1967 to 126 in 1972, but has shown a tendency to decline since. At the end of 1978 there were 190 institutions in the 'public' category, 82 (including 33 'nominee trusts') in the 'restricted' group and 13 in the 'non-active' class.

Besides the provisions relating to the grant of a licence which, incidentally, carries an annual fee varying according to the type of permit, the Act also calls for the publishing* of operating statements within a certain time after the conclusion of the firm's financial year. In addition, the law lays down a heavy penalty for the perpetration of fraud and the fabrication of accounts intended to mislead the public, and permits the Governor to demand a wide range of information in cases where he suspects misdemeanour in the management of a company's affairs, to the extent that it affects the public's interest, or the specific interest of depositors and creditors.

Another far-reaching provision of the 1965 Act was the appointment of an Inspector of Banks and Trust Companies, who is empowered, not only to examine the records of licensees [21], at any time, in order to ascertain their financial position, but also to recommend rectifying measures (through the authority of the Governor) from the perspective of the objectives which the Act sets out to achieve.

The law, it should be noted, contains no specific requirements with respect to capital-asset (or capital-liability) relationship, liquidity or eligible investments. A great deal is left to the discretion of the Bank Inspector's office which is saddled with the responsibility for maintaining a general review of banking practice in the country.

While the legislative changes of 1965 have proved effective in curbing certain undesirable practices devloped during the early 1960s, it is worth noting that the decade immediately following witnessed the collapse of several public-licensed banks, taking with them the funds of a large number

* This provision applies mainly to institutions holding a bank, or a bank and trust licence. Those in the restricted group can seek exemption from the publishing requirement.

TABLE 2.2

GROWTH IN THE NUMBER OF BANKS AND/OR TRUSTS BY TYPE OF LICENCE, 1967 TO 1978
(End of Year Figures)

Type of Licence	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978
PUBLIC												
Bank and Trust	32	36	33	34	35	38	45	40	37	40	43	47
Bank	43	47	81	118	134	138	134	124	122	118	126	133
Trust	15	10	12	12	13	14	12	10	9	10	9	10
1. Total	**90**	**93**	**126**	**164**	**182**	**190**	**191**	**174**	**168**	168	**178**	**190**
RESTRICTED												
Bank and Trust	14	14	15	16	18	18	10	9	6	5	5	5
Bank	26	28	32	30	30	31	23	21	20	20	18	17
Trust	57	62	74	72	78	77	49	36	30	28	27	27
Nominee Trust	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	20	30	30	28	31	33
2. Total	**97**	**104**	**121**	**118**	**126**	**126**	**102**	**96**	**86**	**81**	**81**	**82**
NON-ACTIVE												
Bank and Trust	6	8	10	8	7	6	7	5	7	4	4	3
Bank	6	4	5	6	8	9	14	14	12	8	9	9
Trust	4	4	6	8	8	8	8	8	2	1	1	1
3. Total	**16**	**16**	**21**	**22**	**23**	**23**	**29**	**27**	**21**	**13**	**14**	**13**
1+2+3	**203**	**213**	**268**	**304**	**331**	**339**	**332**	**297**	**275**	**262**	**273**	**285**

Source: the Central Bank of the Bahamas.

of depositors located in various parts of the world.[22] Many of these were institutions set up before the enactment of the Banks and Trusts legislation, thus escaping the scrutiny which the management and promoters of new enterprises now undergo. Another factor was, no doubt, the inability of the Bank Inspector's office with a limited staff at the time to keep a systematic check on the hundreds of institutions located in the country. Under the present arrangements it is not impossible for an institution to run into financial difficulties before corrective pressure could be brought to bear upon it. At the moment, while all licensees are required to submit a copy of their annual financial report to the Bank Inspector's office, only authorised dealers and a select number of other institutions, engaged in local operations make detailed monthly submissions to the Research Department of the Central Bank.

Under the present system, therefore, it is difficult to maintain a continuous check on the assets mix of the banks, both as regards liquidity and quality, not to mention investment practices and loan policies which could only be assessed through more intensive examaminations.

Banks and the Exchange Control Regulations

The financial system of the Bahamas can usefully be divided into two components, a domestic sector and an 'offshore' sector. The latter comprises institutions which deal exclusively in foreign currency transactions and these are designated as 'non-resident' for exchange control purposes. Institutions which are permitted to conduct Bahamian dollar business carry 'resident' status.[23] 'Resident' financial organisations which desire to deal in gold and foreign exchange (which may involve 'offshore' business as well) are designated 'authorised dealers' by the Central Bank which administers the Exchange Control Act of 1952 and related regulations. Another term used is that of 'authorised agent' which gives the entity so designated the authority to deal in Bahamian and foreign currency securities and to act as depositaries for certificates of title to these securities. An institution may have both status at the same time. At the end of 1978 11 banks were acting in the capacity of authorised dealers. Of these 11, four also had authorised agent status, while another five institutions (all trust companies) were acting in an agent capacity only.

Association of Clearing Banks

This is a group of seven authorised dealers (the major banks in the domestic market) who are members of the central clearing system, first set up in March, 1970, with the collaboration of the Bahamas Monetary Authority and intended to clear claims on one another by simple offset. Initially, the Authority played no more than a passive role providing a Clearing Superintendent and keeping daily accounts for each bank. Business with the banks could only be transacted in sterling, in currency notes and coin or through its own Bahamian dollar accounts with commercial banks.[24]

In June of 1971, a new arrangement was worked out with the banks by which they agreed to hold current accounts with the Authority and to conduct their relations with the latter on the basis of adjustments to these accounts. From an accounting point of view there were two main advantages to the new system. Firstly, it enabled the Clearing Banks to increase or decrease the pool of Bahamian dollars available to them against sales or purchases of sterling with the Authority, according to their need for liquidity; and secondly, it enabled the BMA to settle with a bank by simple debit or credit to its account at the Authority.

The overall effect of the new arrangement was that it facilitated the settlement of a wide range of transactions which are a normal part of the relations between the government agency responsible for the issue of currency and the commercial banking sector.[25]

The members of the Clearing Association are as follows: Bank of Montreal (Bahamas and Caribbean) Ltd., Bank of Nova Scotia, Barclay's Bank International, Canadian Imperial Bank of Commerce, Chase Manhattan, Citibank and the Royal Bank of Canada.

The Existing Setting

The presence of the commercial banks in the Bahamas has been motivated by a number of diverse factors, most of them of relatively recent origin. As pointed out in the previous section, the growth of the banking sector has largely been a postwar development, coinciding with the tremendous growth in income that has followed the opening up of the Bahamas as a tourist resort and as a financial centre. It should be noted, too, that this expansion in Bahamian banking facilities came at a time of growing competition among international banks for the business of both corporate and non-corporate clients at both a national and international level.

While entry into many markets were, indeed, motivated by the local deposit and foreign exchange business, in a few cases there were additional factors involved such as the desire to escape national regulations of various kinds prevailing in many countries, and to offer to clients services related to bank secrecy, safety and tax free arrangements. These latter types of services, of course, could only be provided within a particular kind of regulatory framework which only some countries like the Bahamas were willing to operate. It is the policies pursued by successive Bahamian Governments in this context, which explain, in large measure, the differences in the pattern and growth of the financial structure, when compared with those of other Commonwealth Caribbean countries which have chosen different paths of development.

While internal efforts and the tax and administrative system were important, contributory factors in the emergence of the Bahamas as a tourist resort and financial centre, the real propelling forces were largely external. One such factor, of which we have already made mention, was the hemispheric isolation of Cuba in the early '60s, which did much to divert sections of the rapidly expanding American tourist market to the Bahamas. Another was the developments taking place in the money and financial markets of America and Europe in the late '50s and '60s which set in train new forms of financial intermediation leading to greater collaboration among international banks, both in functions and organisation, and which called for a more strategic spread of network activities. Thus, while many of the financial institutions in existence today were attracted firstly by the prospects of expanding domestic business, others sought merely to use the Bahamas as a base or conduit for the conduct of their international operations, local transactions forming a negligible proportion of their total business.

In Table 2.3 and 2.4 we present a breakdown of the assets and liabilities of the banking system by currency for the period 1969 to 1978. The figures, it should be emphasised, represent the unadjusted summation of the banks' balance sheets and relate only to the authorised dealers and not to the Euro-currency banks engaged exclusively in external operations. The rough balance between foreign currency claims and foreign currency liabilities indicates that a large part of their business has little to do with their activities in the Bahamas. While the bulk of it relates to external transactions (Euro-currency business), the figures, it should be noted, include the balances held by correspondents abroad and vice versa. The liabilities data also include deposits (with corresponding assets on the other side) of local entities permitted to hold foreign currency accounts and the Bahamian dollar balances of non-residents holding foreign currency claims on the Banks.

A significant point to note about Tables 2.3 and 2.4 is that the close matching between assets and liabilities denominated in the various currencies would seem to indicate that currency transformation (switching) does not take place on a large scale. This practice, it should be noted, is by no means peculiar to the Bahamas. An examination of the data published by the Bank for International Settlements and relating to European banks shows roughly the same pattern. The major reason for this lies in the fact that liabilities incurred in a particular currency would, for obvious reasons, require that the counterpart assets be held in the same currency. Differentials in interest rates can, of course, at times be sufficiently large to encourage a certain amount of switching. Generally, however, the tendency is for Euro-banks (i.e. banks dealing in the Euro-currency markets) to match their assets and liabilities in the various currencies.

In the context of the foregoing discussion, we might point out that the switching of funds from one currency to another does have implications for exchange rate policies and the fact that Euro-currency operations make possible significant large scale transformations (which on occasions have actually taken place) has, in recent years, given rise to a great deal of concern over their effects on the international exchange rate system. A deposit taken in a particular currency, say U.S. dollars and disposed in

TABLE 2.3

TOTAL ASSETS OF COMMERCIAL BANKS BY CURRENCY, 1969 TO 1978
(End of Period)

Currency	1969		1971		1973		1975		1977		1978	
	$m.	% of Total	$m	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total
Bahamian $	293.6	11.6	319.8	6.7	280.0	4.7	281.0	1.6	306.0	1.1	342.5	1.1
Sterling	208.2	8.2	179.4	3.8	83.2	1.4	a	a	a	a	a	a
U S. $	1,880.6	74.1	3,618.5	75.7	4,714.6	78.5	15,233.9	88.5	25,616.1	93.5	31,459.7	97.1
Canadian $	26.8	1.0	32.3	0.7	40.5	0.7	a	a	a	a	a	a
Other	128.8	5.0	628.4	13.1	883.4	14.7	1,709.8	9.9	1,465.9	5.4	582.1	1.8
Total	**2,538.0**	**100.0**	**4,778.4**	**100.0**	**6,001.7**	**100.0**	**17,224.7**	**100.0**	**27,388.0**	**100.0**	**32,384.3**	**100.0**

a: Included in 'Other'

Source: Central Bank of the Bahamas.

TABLE 2.4

TOTAL LIABILITIES OF COMMERCIAL BANKS BY CURRENCY, 1969 TO 1978
(End of Period)

Currency	1969		1971		1973		1975		1977		1978	
	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m	% of Total
Bahamian $	281.3	11.1	309.3	6.5	263.1	4.4	276.2	1.6	309.2	1.1	350.9	1.1
£ Sterling	212.0	8.4	177.9	3.7	77.2	1.3	a	a	a	a	a	a
U.S. $	1,885.8	74.3	3,664.8	76.7	4,786.1	79.7	15,221.2	88.4	25,526.5	93.2	31,485.8	97.2
Canadian $	40.2	1.6	34.2	0.7	30.6	0.5	a	a	a	a	a	a
Other	118.7	4.6	592.2	12.4	844.7	14.1	1,727.3	10.0	1,552.3	5.7	547.6	1.7
Total	**2,538.0**	**100.0**	**4,778.4**	**100.0**	**6,001.7**	**100.0**	**17,224.7**	**100.0**	**27,388.0**	**100.0**	**32,384.3**	**100.0**

a: Included in 'Other'

Source: Central Bank of the Bahamas.

the same currency has a neutral effect on the U.S. dollar exchange rate. If such a deposit, however, is converted into, say, sterling, the effect is downward pressure on the U.S. spot rate (and upward pressure on the forward rate if forward cover is undertaken) and a strengthening of sterling's spot rate (with downward pressure on the forward rate). Theoretically, therefore, the existence of Euro-currency maket would appear to have greatly reduced the scope for independent action particularly in the spheres of exchange rate and monetary policies.

In connection with the conclusion reached in the last paragraph, it is important to remember that monetary authorities are involved only to the extent that conversion takes place either into or out of the national currency. In countries where, like the Bahamas, there are limits on convertibility,[26] national policies (as we shall see later) can be insulated to a large extent from the effects of the external market. Assuming that the reporting forms are properly filled out, the extent of conversion will be reflected in the excess of total B$ assets over total B$ liabilities. A reverse situation implies that B$ liabilities have been transformed into foreign currency assets.

It is worth pointing out here that assets and liabilities denominated in foreign currency are not identical to the concepts of 'foreign assets' and foreign liabilities'. As indicated earlier, the banks have domestic (or resident) liabilities denominated in foreign currency. They also hold domestic claims, repayable in foreign currency. These latter transactions may appear small in the overall balance sheet position, but, as we shall see later, taken in relation to the level of B$ activities certain items (e.g. foreign currency accommodation to local enterprises) can take on significant proportions.

In terms of growth, the total of Bahamian dollar assets of the banking system has lagged significantly behind that of GNP during the 1970s. A glance at Table 2.4 shows that the ratio of B$ assets to GNP dropped from over 70 per cent at the beginning of the 1970s to 41 per cent in 1977. The ratio of total (all currencies) assets on the other hand, has increased dramatically in recent years. At the end of 1977, bank assets were over 36 times the country's GNP, as compared to less than seven times in 1969.

The main source of this expansion in bank assets has been the rapid growth of the banks' foreign business. This can be seen clearly in Tables 2.3 and 2.4 which show that external currency transactions have been growing at a much faster pace than local business. This situation is reflected in the falling share of Bahamian dollar assets in the banks' total portfolio. The proportion fell from over 11 per cent at the end of 1969 to about 1 per cent at the end of 1978 and, from the evidence available, this trend has been continuing. It is worth pointing out that while all the commercial banks are engaged in the foreign currency business, the relative rate of expansion varies from one institution to another. The trend, however, for all of them is an increasing involvement in external operations which clearly offer

TABLE 2.5

TOTAL BANK ASSETS[a] AS A PROPORTION OF GNP[b] 1969 TO 1977

Year	Bahamian Dollar Assets %	Total (All Currencies) Assets %
1969	73.4	634.6
1970	71.1	828.3
1971	78.0	1,166.3
1972	76.7	1,539.8
1973	54.5	1,168.1
1974	40.2	2,080.0
1975	44.6	2,734.0
1976	41.9	3,236.6
1977	40.8	3,651.7

a: End of year figures.

b: At market prices.

Sources: Table 1.4; Central Bank of the Bahamas.

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greater scope for intermediation and profit making. Certain institutions, in fact, which commenced operations doing both local and foreign business have, in recent years, completely shed their B$ portfolio and are now wholly oriented toward the foreign market. With respect to transactions connected with the latter, we might note that the Bahamian authorities exercise no controls on interest rates or stipulate any reserve requirements.

Organisational Structure[27]

In order to put the structure of the banking system in perspective, it is necessary to discuss, briefly, certain organisational aspects of multinational banking and some of the developments that have taken place in this area.

An examination of the operations of multinational banks reveals a great diversity in the forms of presence available to such institutions in seeking to establish contacts or generate business outside their home base. The more common can be summed up as follows: (i) a correspondent or agency relationship; (ii) a representative office; (iii) an affiliate or associate arrangement; (iv) a branch operation; (v) a wholly-owned subsidiary; (vi) a consortium arrangement.

The correspondent or agency relationship is essentially an arrangement worked out with a local institution, often on a reciprocal basis, by which the latter is committed to perform certain services on behalf of the foreign bank. These services can sometimes be very broad and cover such areas as deposit taking, information collection and investigations of customers in addition to the usual commercial facilities related to the conduct of international transactions. While there are certain definite advantages attached to the correspondent system, the volume of business may be of a level that requires a more substantial presence, in which case the foreign bank may choose from a range of possible alternatives, each with its own particular merits and demerits. It may decide, for example, to establish a purely representative office comprising of one or more individuals who can solicit business on its behalf, while, at the same time, keeping a feel on local conditions and generally overseeing the activities of the parent bank in the area. A representative office does not normally conduct any banking business and this is, undoubtedly, one of its main disadvantages, particularly in situations where competing banks have a more functional presence.

In situations where a bank desires a larger presence than a representative office, but is unwilling to assume the full responsibility involved in setting up a branch or subsidiary operation, a relationship which has come to acquire much usage is that of the 'affiliate' or 'associate.' This is applied to a local bank, in which the foreign institution has a minority equity interest. This form of entry into distant markets is increasingly being formed in areas sensitive to foreign investment, or where foreign banks are trying to divest themselves of their colonial image. In countries where the affiliate bank is an established institution this arrangement provides the foreign bank with a ready source of funds and an accumulated knowledge of local conditions and contacts that would not be available to a newly formed institution. One major disadvantage of this kind of arrangement (from the foreign bank's point of view) lies in the potential for conflict, inherent in the ownership structure which, in the ultimate resort, is the major determinant of orientation and policy.

It is possible,as often happens in practice, that an institution may wish to have its own office without any association to other organisations. Two forms of operation open here are the (a) subsidiary and (b) the branch system. The branch office is legally an integral part of the parent establishment. In law, the branch bank does not have an identity distinct from that of the parent company, as is the case with a subsidiary. "No separate shares of stock are issued, nor is a separate board of directors formed.

Although the branch bank maintains a separate set of books for internal purposes, it does not have assets and liabilities of its own."[28] As such the parent bank stands fully behind any credit losses that branches may suffer, even in excess of the branches' invested capital."[29]

In the case of U.S. institutions,[30] the "expenses, losses, or income of a foreign branch are automatically and immediately consolidated with the parent company's operations for computation of taxable income in the United States. A foreign branch has the flexibility of being able to make instantaneous transfers of funds to any other branch in the world-wide network or to the home office." [31]

Although there are a number of drawbacks[32] associated with this type of operation, branch banking has proved to be extremely popular in multinational activities. The motivation behind the branch bank system can be summed up as follows[33]:

(1) to put the entire asset structure and net worth of the home bank behind deposits as a guarantee;

(2) to attract large corporate borrowers by promoting the idea that greater sums can be made available for advances than if sole reliance were to be placed on local deposits and money market funds;

(3) to maintain the maximum degree of central control over the establishment's operation; or simply

(4) to follow a 'traditonal' pattern of overseas expansion.

The form of presence a particular bank may wish to have in a foreign country is not always wholly at the discretion of that institution. There are factors external to a bank's operations that have to be taken into consideration. One of these is the governmental policy of the host country. There are some states, for example, which do not permit foreign branch banking within their borders. An example that readily comes to mind is Mexico. In such cases, the bank would have to settle for a subsidiary operation which can be wholly owned or, as happens in some instances, can be set up in collaboration with local enterprise,[34] the foreign bank retaining a controlling equity interest.[35]

The major difference between a branch and a subsidiary lies in the legal status accorded each. Whereas, as we have pointed out before, a branch operation is treated essentially as an extension of the parent company, the subsidiary is regarded as a separate legal entity, distinct from that of its parent. This distinction is of crucial importance from an accounting (profit) point of view since for "tax purposes the income accrued by subsidiaries is not included in the taxable income of the parent company until the income is actually remitted to the parent."[36]

Besides this accounting factor, there are a number of other considerations which have motivated the formation of subsidiaries in recent years, and these are briefly outlined in the following paragraphs.

Over the last two decades, there have been a number of changes in the international banking and financial system which, in turn, have brought about noticeable departures in the organisation and practices of traditional banking operations. The growth of the Euro-currency market and the new possibilities, opened up in financial intermediation, have attracted an increasing number of banks whose formative structures were largely oriented to operations in the domestic retail market. Advent into the competitive international business quickly revealed the inadequacy of traditional organisation and the need for building up new expertise[37] commensurate with the complex functions involved in the new area of business. This process of adaptation has involved the establishment of wholly-owned subsidiaries in certain key centres. Some of these subsidiaries are owned by single banks while others have been set up by groups of banks.

The purposes and advantages of their establishment are several fold. The most remarkable feature of these institutions, however, is that they tend to engage in activities different from those of the parent and are therefore difficult to incorporate in the balance sheet of the latter. A subsidiary, for example, "can bid for large deposits in the open market, paying competitive rates, without disturbing the rate paid by the parent on the great bulk of its deposits, most of which are individually small. The subsidiary operates in markets where the turnover is high, the administrative cost low and the return on individual transactions very small indeed" [38] The parent, on the other hand, may be subject to statutory cash and liquid requirements which preclude profitable operations in the large markets involving big sums with their own special rates. Again, "a subsidiary operating on a wholesale rather than in retail markets is also far better placed than the parent to match deposits and placings. Since funds of this kind are highly volatile, this is a matter of great importance." [39]

Another and not altogether unimportant consideration encouraging the setting up of separate, almost autonomous companies is the requirement of salary scales structured along lines that can attract the specialised skills necessary for the new activities — an objective that might be difficult to realise within the framework of the parent establishement.

As far as subsidiaries set up by two or more banks[40] are concerned, there are several advantages to this type of operation. The most important of these stems from the fact that an institution backed up by several well-known names is less likely to fail and therefore inspires a greater measure of confidence. Consortium arrangements, involving several big banks, put at the disposal of the subsidiary, resources and expertise far greater than the parent banks would be able to muster in an individual capacity, thus allowing the cooperative enterprise to engage in activities that single bank subsidiaries would be ill equipped to enter. The international network of contacts opened up is an added advantage of this type of operation which has even attracted banks which are organised on a world-wide basis and are powerful in their own right.

Consortium banks follow no standard and they tend to differ both in form and purpose.[41] Some, for example, may have just a few shareholders while others are owned by as many as 20. Banks, it should be noted, are not the only participants in multi-owned financial institutions. Among the shareholders one can find trust operations, insurance companies and even merchant banks. The purpose, too, for which each is formed tends to differ from institution to institution, particularly in respect of type of projects, scale of finance and so forth. Also, while some consortium undertakings operate on an international basis, others have been formed with a particular geographic area in mind.

While the factors that sparked off this new era of multi-bank cooperation appear to be many and varied, a close observation of the situation, however, reveals that the growth of consortium banking has followed closely upon the heels of the geographic spread of multinational corporations whose financial requirements have grown larger and larger over the years with the advancement of technology in various areas of industry. Not only has the size of the loans required grown increasingly large, but the term for which the money is borrowed has also increased. It was in response to fill this need for large medium term credit that several multi-bank institutions[42] were formed during the middle and late '60s within the framework of the Euro-dollar market. Traditional banking organisations geared, as they were, for small scale retail business found themselves totally unequipped to meet the changing needs of the multinational corporations.

To make sizeable loans for long periods meant that the banks had to attract large funds and, given some of the restrictions prevailing in national money markets, this called for the formation of institutions with greater capital resources and more flexible structures capable of operating in the international capital markets. The existence of house limits in many cases imposed an additional constraint on lending activities, thus further enhancing the prospect of losing valuable customers to competitors organised to handle large loans and providing a wider range of services.

With the growth of the Euro-dollar pool in London and the expansion of American enterprise in Europe during the '60s, U.S. banks started moving over to the Continent to take advantage of the opportunities being created, by competing with their European counterparts and former correspondents. It did not take long, however, before the banks from both sides of the Atlantic found that they had advantages which, if combined, could result in a more effective organisation in meeting the total needs of the industrial corporations whose requirements, both in terms of finance and services, were becoming increasingly more complex. While, for example, "American commercial banks such as First National City and Bank of America and a few of the British banks have both size and geographic spread, many of them do not have the required local deposits in other currencies or skill in types of banking activity (notably investment banking) forbidden them by law at home. Continental banks, in general, have the full range of skills appropriate to 'universal banks' but lack financial clout and an international network branches.''[43]

The blending of these assets meant that not only were the national and international capital markets brought closer together, thereby facilitating the granting of multi-currency loans, but the subsidiary was better placed to provide the range of services (such as financing of mergers, counselling, acquisitions, market investigations, etc.) being demanded by clients of the parent banks. Far from duplicating the efforts of the parent instititutions, therefore, consortia subsidiaries have complemented the marketing efforts of their shareholders by developing new expertise particularly in areas outside the reach of their individual shareholders.

The consortium arrangement has also served as a useful vehicle for many small banks to enter the international banking arena from which their meagre resources and limited organisation had precluded them in previous years. For the larger banks themselves the prospect of realising economies of scale in their operations in a highly competitive field and learning from each other has not been an unimportant consideration, even if the synergetic motivation we mentioned earlier, has been the dominant one.

Organisational Situation in the Bahamas

Having looked at some of the possible forms of organisations open to a commercial bank in the geographical expansion of its business, we now turn our attention to a brief examination of the situation in the Bahamas and some of the specific factors which have contributed to making this country a popular base from which to conduct international financial operations.

At present, the commercial banking sector comprises a diverse collection of some 11 banks,[44] all of which have some kind of relationship with foreign financial institutions either as branches, subsidiaries or as consortia (see Appendix 2.1). Table 2.6 presents some details of the number of banks under the various forms of organisation and the country of the parent company. Of the 11 banks, six operate as branches and five as subsidiaries, four of the latter being owned by or affiliated with single institutions, while the fifth is the creation of several international financial institutions. The Bahamas serves as a base for the latter as it does for the Bank of London and Montreal for its extensive interests in the Caribbean and Latin America. We should point out that there are other institutions (including at least one other known consortium) which use the Bahamas as a base from which to conduct their international operations, but these are not involved directly in the Bahamian dollar business.

TABLE 2.6

COMMERCIAL BANKS BY TYPE OF ESTABLISHMENT AND COUNTRY OF HEAD OFFICE (POSITION AT END OF 1978)

	Countries of Head Office				
Type of Establishment	**U.K.**	**U.S.**	**Canada**	**Bahamas**	**Total**
Branches	1	2	3		6
Subsidiaries	2	1	1		4
Consortia				1	1
Total	3	3	4	1	11[a]

a: Includes one bank which holds an authorised dealer license but which is not active in the domestic banking scene. The government-owned People's Penny Savings Bank is not included in the figure.

Source *Bahamas Handbook,* various issues; Central Bank of the Bahamas

Even if we exclude the purely offshore institutions (which we saw earlier currently number more than 250), for a developing country of little over 22,000, the number of banks serving the Bahamas is relatively large, particularly if one takes into account the number of branches in operation. This rather unusual situation, as well as the particular structure described, requires some further comments. Traditionally, Caribbean countries have been served by a small number of North Atlantic banks using the branch bank system which is still in operation in several countries of the region. In recent years, however, in response to the growing social and political pressures for a greater measure of national participation in the economic system, some of these banks[45] have resorted to the strategy of setting up local subsidiaries with varying degrees of parent participation, rather than close altogether. In the Bahamas there have been no such factors influencing the structure of the banking system.

The form of establishment chosen is based largely on the economic and strategic considerations which the Bahamian tax and administrative system makes possible, and which fits best into the international activities of the parent bank(s) within the context of the legal and institutional framework within which they operate. Since banks which have traditionally exploited the domestic maket of Caribbean countries have generally shown a preference for the branch type operation, it can be inferred from this that institutions which have chosen to operate on the basis of locally formed companies in the Bahamas have done so with the aim of doing external business with which the advantages of subsidiaries are mainly associated, as we saw earlier. It would appear, therefore, that the motivating force behind the formation of these organisations in the Bahamas has been the locational factors upon which we have already briefly touched. Specificially, they include the freedom to operate in the external markets and the absence of regulations governing these activities, proximity to the United States, the availability of excellent telecommunication facilities, and the existence of a tax haven environment with all that this implies in terms of direct taxes, exchange control and international secrecy arrangements relating to the operations of non-nationals in the country.

It is appropriate to note, here, that while Bermuda offers similar facilities, the government exercises a very tight control over banking operations in that country. At the moment there are only four banks, two of which are almost wholly owned by Bermudans. The other two are affiliated with international institutions. The Government requires that all banks must be owned, at least 60 per cent, by Bermudans. As far as the Cayman Islands are concerned, the number of institutions registered there is growing, but this country still lacks many of the features (e.g. adequate air transport facilities) which have contributed, in no small measure, to the tax haven prospects of the Bahamas. It might be pointed out that several Bahamas-based institutions which have seen it fit, for one reason or another, to set up an office in the Caymans, have also at the same time sought the permission of the Bahamian authorities to conduct the business of their Cayman office from Nassau.

Inter-company Relationships within Group Structures

A feature of the financial sector worth noting, and one that can have tremendous implications for policy formulation and decision-making, is the peculiar group structure that has emerged in response to the changes that have taken place in the tax and regulatory system of certain countries and to developments in the international money and capital markets. One striking development has been in the field of trust operations which most of the commercial banks have entered, either through departments or by establishing separate companies, many of which themselves have become deeply engaged in the foreign currency business arising mainly from the management of funds in a fiduciary capacity. The consumer and mortgage finance houses are themselves also closely affiliated with banks and in at least one known case with an insurance company.

In certain instances banks operating in or from within the Bahamas are linked to outside financial institutions through joint participation in third organisations, designed to perform functions which the shareholding units are apparently unable to undertake. These relationships and the strategies lead to the creation of a kind of financial synergism both domestically and on an international scale, one level reinforcing the other in providing a diversified structure capable of meeting a wide variety of needs. The relationship between the cooperating entities is not always clear, particularly when the aim of structural rearrangements is not the elimination of competition. The evidence has shown that competition between entities belonging to the same organisation can be very fierce to the point of disturbing long standing status quo situations.

While there are differences in the assumptions and objectives on which the various types of financial institutions operate, the potential intra-group resource flow, inherent in the kind of associate framework described above, does raise a number of important questions both for policy and instrument formulation in a setting involving greater central control and management. The issue raised here will undoubtedly become evident as the central bank begins to regulate credit and liquidity conditions through the use of cash and liquidity requirements.

The Effects of Institutional Changes on the Balance Sheet of the Banking System.

In an earlier section, attention was drawn to the great influx of banks into the Bahamas in the post-war period and to the general nature of their operation. Concomitant with this growth in the number of enterprises attracted to this country, there occurred an equally rapid expansion in the assets and liabilities of the banking system. In the following pages the analysis will focus on the changes that have taken place in the structure of the banks' balance sheets and some of the factors that have influenced these changes.

In 1950, as indicated earlier, there were two commercial banks doing business in the Bahamas, viz., the Royal Bank of Canada which had established a branch in the very early part of the century (1908) and Barclays Bank D.C.O. which had come in 1947. Between them they had four branches and operations were largely confined to Nassau around which, even then, most activities in the Bahamas were centred. New Providence alone contained more than half of the total population. The banks were expatriate, being part of an international network based in Montreal and London respectively and operations followed very closely the pattern observed in other British colonial territories. The combined balance sheet of the two institutions at the end of 1950 is presented in Table 2.7 which reflects the operational characteristics of the system as it functioned then. The banks, as can be seen, brought in no capital of their own and resources were derived almost wholly from deposits, principally demand accounts. Their local lending policies were influenced to a great extent by the standards employed at home, and this made it extremely difficult to find enough local credit-worthy borrowers to utilise fully available funds. Even where it appears that some resources were retained locally, very often these were credit extensions to expatriates with business connections in the metropole,

TABLE 2.7

ASSETS AND LIABILITIES OF THE BANKING SYSTEM
AT THE END OF 1950

Liabilities	$'000	Assets	$'000
Deposits		Cash	820
Demand	19,568	Loans & Advances:	
Savings	4,415	Industry	23
Time	1,192	Agriculture	9
		Other	4,150
Balances Due to Other Banks.		Investments:	
In the Colony	—	Local	—
Abroad		Other	—
U.K.	31		
U.S.	86	Balances Due from Other Banks:	
Canada	—	In the Colony	37
Elsewhere	—	Abroad:	
		U.K.	18,473
		U.S.	1,064
		Canada	269
		Elsewhere	226
Other Liabilities	273	Other Assets	494
Total Liabilities	**25,565**	**Total Assets**	**25,565**

Source. Returns to government authorities.

and who were probably well known to the banks.

Besides loans, there were no other local outlets for the temporary employment of deposit funds, and, therefore, resources that could not be loaned locally were remitted abroad, mainly to London. The parent bank could then invest these funds in some form of British security or shift it to branches in other areas were there was a temporary shortage. A look at

Table 2.7 shows that at the end of 1950, over three-quarters of the banking system's total assets took the form of 'Balances Due from Other Banks Abroad', giving us an idea of the extent to which funds were channelled out of the country as a result of the operational orientation of the banking system.

Generally, funds are not remitted out of a country if the expected returns do not exceed the double transfer charges that would be involved in such an operation. Another and perhaps even more important consideration in moving from one currency to another is the exchange risks, inherent in such transactions, which could result in significant financial losses if the local currency appreciates before the re-transfer is effected. The colonial monetary systems, however, with their close link to sterling, with which the local currencies were freely exchangeable at rates politically determined in London, greatly reduced the possibility of capital depreciation arising in this fashion. It was not surprising, therefore, that even the Canadian based banks tended to keep their reserves at their office in the British capital where there was a wide range of opportunities for their employment.

It has not been possible to locate the statistical returns relating to local operations of the banks as made to the government authorities over the period 1950 to 1965, assuming these statements were in fact submitted. Such returns as are available between the latter year when the Banks and Trust Companies Regulations Act was passed and 1968 are in consolidated form with no distinction being made (and was not required) between domestic business and other operations. It was not until the establishment of the Bahamas Monetary Authority in 1968 that monthly returns showing a division between their Bahamian dollar business and external currency transactions became a formal requirement of the commercial banks. With this gap in the statistical data and the general absence of other related statistics pertaining to the sectoral distribution of loans, it is not possible to say very much on the level and pattern of resource disposition in the evolving economic and financial framework of the '50s and '60s, and consequently on the role of the banks in the postwar economic upsurge. It is likely that with the expansion of economic activities and the consequent growth of personal incomes in the '50s and '60s, a greater proportion of banks' resources would have found an outlet in the domestic economy. The entry of new banks may also have contributed to this trend. The sterling devaluation of 1967, however, and the events to which it gave rise, revealed that even up to that time the banks still maintained heavy balances abroad,[46] a great portion of which was subsequently repatriated.[47] Figures available for the post-1969 period (Tables 2.8 and 2.10) show that not only has the item 'due from head office or banks abroad' shown a tendency to decline in absolute terms, but as a proportion of the banking system's total deposit liabilities, it has also been decreasing, as the banks are being forced, both by national regulations and international monetary conditions, to find greater domestic uses for locally generated resources. As a result of recent political developments and changes in the institutional environment in which

TABLE 2.8

NET BALANCES OF COMMERCIAL BANKS HELD WITH BANKS ABROAD 1950 – 1978

B$'000

End of Period	(1) Due to H/O or Banks Abroad	(2) Due from H/O or Banks Abroad	(3) (2) – (1)
1950	117	20,032	19,915
1969	1,896	11,893	9,997
1970	152	6,964	6,812
1971	424	2,564	2,140
1972	3,909	3,565	–344
1973	270	2,554	2,284
1974	1,414	245	–1,169
1975	1,791	178	–1,613
1976	321	2,566	2,245
1977	1,501	3,016	1,515
1978	5,317	3,579	–1,738

Note: While figures from 1969 onwards may be subject to error arising from individual bank's interpretation of the requirements in the reporting form which lists assets and liabilities according to the currency in which they are repayable thereby creating room for some confusion, the broad trend shown in the table seems largely correct.

Source: Central Bank of the Bahamas.

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financial institutions in British colonies have traditionally functioned, the combined balance sheet of the commercial banks, in recent years, shows a dramatic change in many ways from the 1950 statement we discussed earlier. This has not meant, however, as will be seen later, that the banks are yet playing the role required of them in the development of the Bahamian economy and in the efforts aimed at increasing the well-being of the society, in both of which tasks they have a crucial part as intermediaries to play.

As indicated earlier, while the banks have been submitting monthly returns with a breakdown between their local and foreign business to the Monetary Authority (now the Central Bank) since the beginning of 1969, the reporting form, used until the end of 1973, not only lacked the detail of the form currently being employed, but was structured in such a way as to lead to easy misinterpretation of certain items. Hence, there is ambiguity surrounding the reliability of some of the data procured under those forms. Unable, therefore, to present an item by item comparsion from 1969 in examining the growth of the banking system, a summary is presented in Table 2.9 of the local assets of the commercial banking system since 1973 as published by the Central Bank. Before discussing the details of this table, it is necessary to make a few general comments on the approach used in its compilation.

It was pointed out earlier that some of the local transactions of the banks are denominated in foreign currency and it is therefore not an easy matter to obtain a strict separation between domestic business and external or 'offshore' operations. The banks not only hold foreign currency deposits for residents (to the extent that this is permitted) but also make loans to residents in foreign money. The bulk of the latter has its source in the foreign liability position of the lending institutions. Table 2.9 includes these transactions as well as the Bahamian dollar business of banks. One would therefore observe a difference between these figures and those used elsewhere in the study in analysis concerned solely with local currency operations.

In the old days, with the free movement of funds within the sterling area and the pegging of the local currency to sterling, it was possible, as we pointed out earlier, for the banks which were operating in several territories to shift resources from one area where there was a surplus to a deficit area. Both situations were determined by the operating policies of the institutions which were concerned more with maximising income for the company as a whole than with the net results of any particular branch. In these conditions, therefore, it was possible to loan in one territory funds in excess of the deposits taken in that country. There were, however, definite limits to the extent to which the banks would be willing to make 'excess' credit available in one area, the most immediate factor in such circumstances, of course, being the availability of resources itself, after primary reserves needs had been met. In the context of the nature and structure of the banking system in the Bahamas today, the latter consideration is far less important for reasons we have indicated earlier. The risk of a change in currency parity now however, is far greater than it was, say, before 1967, raising the possibility of serious capital losses in cases of loans made on the basis of converted currency. To be sure loans financed in this way are still being made within, and occasionally, in excess of the limits laid down by the authorities for exchange control purposes. On closer examination, it would seem, therefore, that one of the most distinguishing features of the present system is the greater potential at its disposal for expanding local credit on the basis of outside resources, notwithstanding the greater risks in certain directions to be met in the environment of today. The presence also of a larger number of banks and the existence of a local interbank market for funds has

TABLE 2.9

ASSETS COMPOSITION OF THE COMMERCIAL BANKS, 1973 TO 1978 (End of Period)

$m.

Items/Year	1973	1974	1975	1976	1977	1978
1. Notes and Coin	11.8	9.3	9.7	10.4	10.4	11.7
2. Balances with Central Bank	3.6	11.1	12.6	10.9	10.0	13.3
3. Balances with Other Local Financial Institutions	17.1	1.3	7.6	2.4	1.8	2.2
4. Government Securities:						
Treasury Bills	7.6	4.6	9.3	9.3	15.0	10.0
Other	17.3	23.9	28.0	35.0	38.6	47.2
5. Other Local Securities	11.1	5.9	6.1	5.2	4.5	3.3
6. Net Foreign Assets	(124.3)	(142.2)	(130.8)	(107.3)	(134.9)	(130.6)
7. Loans and Advances						
Government	4.0	29.8	30.4	33.4	33.9	32.7
Public Corporations	9.9	2.1	0.4	10.6	24.6	21.7
Other	276.0	259.2	257.1	259.7	282.1	306.0
8. Other Assets	19.4	20.1	21.2	16.4	19.9	28.4
Total Assets	**253.5**	**225.1**	**247.4**	**289.7**	**307.2**	**345.9**

Source: Central Bank of the Bahamas, *Quarterly Review*, December, 1978.

created a framework for the more efficient management of financial resources.

In connection with the statement on foreign assets made above, a word of caution needs to be advanced in the interpretation of Table 2.9. Earlier in our discussions, we saw that the net amount due from head office or banks abroad was a good indication of the local bank's total foreign assets or external reserves in the particular context of the system in which it functioned. Given the changes that have taken place in the operations of the banks, this definition is not only no longer adequate, but has to be viewed against the background of their external business to which the bulk of their assets is related. In other words, the foreign currency assets are derived from foreign currency liabilities, though a small proportion might have arisen from their Bahamian dollar business in earlier years when the sterling area was in existence and exchange controls less stringent. It is, therefore, both incorrect and in fact misleading to view the external currency part of the banks' balance sheet as an integral part of, or intimately related to their domestic operations. This situation not only poses a problem in arriving at macro-economic quantities for analytical purposes, but also carries with it policy implications, even if the local institutions concerned exercise control over the resources reflected in the balance sheets. Once the local and foreign activities of the banks are treated together (and there is some basis for this), the figures relating to the latter are so large in relation to those of the former, and the nature of the transactions involved so different, that it becomes well nigh impossible to make inferences about the local situation on the basis of movements in the total figures. The banks, themselves, it should be noted, tend to view their domestic and external business as separate operations, though as indicated, there is some connection between the two in the form of foreign currency accommodation to residents, and transactions of an external nature taking place between local institutions.

COMPOSITION OF LOCAL ASSETS

Between 1950 and 1978 the total Bahamian dollar assets of the commercial banking system increased fourteenfold. Concomitant with this trend, as indicated earlier, there has been a number of developments bearing on the local constraints of the banks and their operational policies and framework. This is reflected, to some extent, in the proportion of local loans and advances to total B$ assets. Whereas the ratio was only 16 per cent in 1958, by the end of 1978 it had increased to over 50 per cent. We have already drawn attention to some of the main influences affecting portfolio policies and some of the general principles to which they adhere. It is clear that one of the most important factors distinguishing the situation in the 1950s from that in the 1960s and 1970s is the vast amount of resources available in the international markets and the willingness of the

TABLE 2.10

SELECTED ASSETS OF COMMERCIAL BANKS
AS A PERCENTAGE TOTAL B$ DEPOSITS, 1973 TO 1978

End of Period	Till Cash	Balance with CBB	Treasury Bills	Other Government Securities	Net Foreign Assets	B$ Loans and Advances[a]
1950	3.25	–	–	–	79.26	16.61
1973	7.31	2.25	4.68	11.31	(63.17)	99.34
1974	5.24	6.24	2.62	14.27	(54.44)	87.96
1975						
March	3.00	8.58	6.81	13.42	(52.68)	87.01
June	3.28	13.83	7.40	12.05	(55.02)	83.48
Sept.	3.71	7.95	5.97	15.19	(61.65)	81.86
Dec.	4.97	6.47	4.76	14.38	(63.92)	80.91
1976						
March	3.10	13.69	6.30	12.91	(60.72)	76.31
June	3.18	11.72	6.88	12.77	(71.56)	78.61
Sept.	3.44	6.14	5.94	16.35	(46.69)	79.71
Dec.	4.57	4.78	4.06	15.31	(46.83)	79.30
1977						
March	3.20	9.86	4.80	15.05	(38.18)	71.53
June	3.14	11.94	5.69	13.82	(44.32)	75.06
Sept.	2.68	5.14	6.16	13.90	(59.10)	80.85
Dec.	4.39	4.17	6.30	16.24	(56.60)	78.86
1978						
March	2.77	11.18	6.07	15.15	(54.55)	73.96
June	2.39	7.23	5.83	20.43	(58.31)	74.88
Sept.	2.36	7.82	5.08	17.79	(56.27)	75.26
Dec.	4.25	4.80	3.62	17.06	(47.25)	76.75

a: Excludes loans and advances to Government.

Source: Central Bank of the Bahamas, *Quarterly Review,* various issues.

authorities to allow the banks to participate in these markets. Access to external funds has significantly enhanced the lending capability and flexibility of financial institutions to whom the administrative regulations are now the more relevant instruments of control and the real constraints on the banks.

Notes and Coin

This item refers to cash held by the banking system to conduct its day to day business. It does not include foreign currency held by the banks, which often amounts to as much as half of B$ cash. As a proportion of total B$ deposits, cash rarely exceeds a range of 2 to 4 per cent, the ratio tending to move towards the upper limit as the end of the year approaches, in order to meet the heavy cash withdrawals that take place around this time. Since the required proportion is 1 per cent, it means that the actual ratio has generally been more than twice the prescribed limit. From the point of view of the authorities, the level of the statutory requirement set would be influenced not only by considerations of liquidity or solvency, but by perceptions of effectiveness in the context of the use of monetary controls. Since cash in till is a non-earning asset, the amount held above the legal stipulation, on a daily basis, would tend to reflect a balance of the need by the banks to hold sufficient funds to meet ordinary working demands and the necessity to minimise loss of earnings from resources at their disposal. Taking these factors into account, the cash ratio for the banking system in the Bahamas is relatively low and this is, undoubtedly, made possible by the somewhat ready sources of funds to which access can be had in the event of a liquidity problem. In this connection, it is worth noting that there appears to have been a slight lowering in the ratio since the coming into being of the Central Bank. The absence of large fluctuations in the ratio can, perhaps, be explained by the constant injection of cash from an all year tourist trade and a somewhat even expenditure flow.

Balances with the Central Bank

One of the earliest views advanced for the institution of legal reserve balances is related to the need to keep the banking system liquid. A later interpretation saw the measure principally as a means of providing the Central Bank with funds. Whatever effects cash reserve requirements may have in these two particular aspects, the main purpose behind the adoption of the variable reserve device in postwar years relates to its use in affecting domestic credit conditions.

Reserve regulations stemming from the Central Bank Act did not become effective until 1 July, 1974. These regulations require commercial banks to hold in reserves, funds amounting to 5 per cent of their Bahamian dollar deposit liabilities.[48] Of this 5 per cent, 1 per cent or the average till cash held during the previous month (whichever is less) is to be held by the banks while the remainder is to be kept with the Central Bank. No interest is paid on statutory deposits.

Previous to this, as indicated earlier, reserve arrangements were governed by an agreement (effective from 1 June, 1971) between the Bahamas Monetary Authority and the seven clearing banks in which the latter undertook to maintain in till cash or, on balances with the BMA, an amount equivalent to 5½ per cent of Bahamian dollar deposits. Within this minimum, at least 1 per cent of B$ deposits was to be held in accounts with the Authority. The arrangement had no statutory basis and was instituted with the limited objective of facilitating inter-bank dealings and transactions between the BMA and the banks. Despite the lack of legal compulsion, overall, the clearing banks consistently maintained a position above the minimum requirements.

A glance at Table 2.11 shows that, since the institution of the legal requirements, excess reserves maintained by the banking system have increased even further. During 1978, the average of the end of quarter balances was $15 million. At the end of May during the same year, the figure stood at $30.7 million. Generally, the second and early third quarters in the year appear to be periods of relatively high liquidity. As a percentage of B$ deposits, balances with the Central Bank tend to fluctuate widely. For example, while at the end of the first quarter in 1978 the ratio was 11.18 per cent at the end of the fourth it was 4.80 per cent. The same pattern could be observed for previous years.

Due by Authorised Dealers and Other Financial Institutions in the Bahamas.

As is clear from the heading, this item has two parts. A glance at Table 2.9 will show that the first part has been omitted in the netting out process used to compile the data in that table. The bulk of the figures relating to outstanding balances with authorised dealers reflect transactions in the local inter-bank market which has both a Bahamian dollar and a foreign currency component. While the latter is related to the external business of the banks, the former has performed a useful function in local banking actitivies, acting both as an outlet for funds in temporary surplus and as a source of liquidity in correcting positions between individual banks. The corresponding item on the liabilities side would be 'Due to Authorised Dealers' and the two should normally be equal to each other. Inequality, however, may come about as a result of the time factor involved in the despatch and receipt of information relating to transactions between individual institutions. With respect to balances outstanding with other financial institutions, these largely represent accommodation made by some of the commercial banks to associated financial companies for employment in their own line of business.

Treasury Bills

Though the Treasury Bill Act was passed in 1959, the first issues were not made until 1962. When first introduced, the Bill was intended mainly to assist Government with the normal cash flow problem that arises from differences in revenue and expenditure patterns in the fiscal year. During

TABLE 2.11

RESERVE POSITION OF COMMERCIAL BANKS IN RELATION TO REQUIRED BALANCES,[a] 1971 – 1978

$m

Year[b]	(1) Average Till Cash	(2) Average Balance with CBB	(3) (1) + (2)	(4) Required Reserves	(5) Excess or (Deficiency)
1971[c]	7.2	2.4	9.6	7.9	1.7
1972	7.5	7.3	14.8	8.5	6.3
1973	8.0	8.5	16.5	9.0	7.5
1974[d]	7.4	10.4	17.8	9.1	8.7
1975	6.6	17.0	23.6	9.4	14.2
1976	7.3	19.2	26.5	10.5	16.0
1977	8.4	19.4	27.8	11.9	15.9
1978	7.9	19.8	27.7	12.8	14.9

a (i) Under an agreement with the clearing banks, the latter were required to hold (from 1 June, 1971) in cash or with the Central Bank (then the BMA) an amount equal to 5½ per cent of Bahamian dollar deposits. At least 1 per cent was to be placed with the Central Bank.

(ii) The legal reserve requirements for the banking system (4 per cent with the Central Bank and 1 per cent in till) came into effect from 1 July, 1974.

b: Average of end of quarter balances.

c. Based on first three quarters.

d: Average of end of month balances, July to December.

Source : Central Bank of the Bahamas, *Quarterly Review,* various issues.

the latter part of the 1960s Bills were denominated both in Bahamian dollars and United States currency, the latter being used to settle foreign commitments. With an increasingly liquid situation developing during the late '60s/early '70s, the device became an extremely useful instrument for the employment of short term funds by the financial community, and has continued to remain so (though rates have been falling in recent years) in a situation were there are not many other competing outlets. The process of issue has moved from an initial system of private placement to one of public tender. One feature which has no doubt contributed significantly to the attractiveness of this medium has been the decision to make it a marketable asset which could be sold before maturity. This decision was taken even before the Central Bank came into being in 1974. Its predecessor, the Bahamas Monetary Authority, had, as far back as April 1971 informed the clearing banks that it stood ready at all times "to sell Bills from its own portfolio, to discount Bills for banks before maturity or to lend, for a mimimum of seven days against the collateral of Treasury Bills. . .". [49]

Treasury Bills are now held by a wider range of investors than was initally the case. Commercial banks, however, continue to be the main lenders. The total amount outstanding increased from $2.0 million at the end of 1963 to $14.0 million at the end of 1978. Of the latter figure, the banks were holding $10.0 million or over 70 per cent. As a proportion of B$ deposits holdings of Treasury Bills have increased in recent years, the ratio moving from less than 1 per cent at the end of 1969 to a figure of 4 to 6 per cent in recent years.

Other Government Securities

The item refers largely to government medium and long term stock, the first issue of which was made in May of 1974. Before this, government had borrowed funds from financial institutions, but the transactions involved no issue of marketable or discountable instruments.[50] Since 1974, there have been further securities offers, which generally have tended to be oversubscribed.[51] The public debt outstanding under government securities other than Treasury Bills increased from $23.5 million at the end of 1974 to $112.6 million at the end of 1978, or more than four-fold. The foreign currency component, however, declined from $6.4 million to $4.0 million over the same period.

Government securities are a gilt-edged investment and it is not surprising that financial institutions find it easier to acquire this asset than to get involved in more risky activities that may also be associated with greater administrative costs from their own private point of view. Table 2.12 shows the holders of all government securities denominated in both Bahamian dollars and foreign currency between 1973 and 1978. With respect to the Bahamian dollar component, the holdings of the commercial banks increased from $17.6 million at the end of 1974 to $43.7 million at the end of 1978. The percentage share, however, of total outstandings declined from 74 per cent of 38 per cent over the period. The banks' share of the foreign

TABLE 2.12

HOLDERS OF GOVERNMENT REGISTERED STOCKS AND OTHER SECURITIES OUTSTANDING, 1973 TO 1978 BAHAMIAN DOLLARS
(End of Period)

Holder	1973		1974		1975		1976		1977		1978	
	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m	% of Total	$m.	% of Total
Private Sector	–	–	0.2	0.8	0.3	0.8	0.8	1.3	1.4	1.6	2.6	2.3
Public Corporations	–	–	–	–	6.0	16.7	16.0	26.0	36.2	42.2	47.3	41.5
Central Bank	–	–	0.3	1.3	0.0	0.0	4.0	6.5	–	–	1.4	1.2
Commercial Banks	10.6	82.2	17.6	73.9	22.6	62.8	30.6	49.7	34.0	39.6	43.7	38.3
Insurance Cos.	0.8	1.2	2.0	8.4	2.5	6.9	4.5	7.5	6.3	7.4	8.1	7.1
Other Local Financial Instits.	1.5	11.6	3.7	15.6	4.5	12.8	5.7	9.2	7.9	9.2	10.9	9.6
Total	**12.9**	**100 0**	**23.8**	**100.0**	**36.0**	**100.0**	**61.6**	**100.0**	**85.8**	**100.0**	**114.0**	**100.0**

FOREIGN CURRENCY

Holder	1973		1974		1975		1976		1977		1978	
	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total
Commercial Banks	6.7	39.2	6.2	36.3	5.4	36.7	4.5	36.6	4.6	23.2	3.5	21.3
Other Financial Instits.	10.4	60.8	10.9	63.7	9.3	63.3	7.8	63.4	15.2	76.8	12.9	18.7
Total	**17.1**	**100.0**	**17.1**	**100.0**	**14.7**	**100.0**	**12.3**	**100.0**	**19.8**	**100.0**	**16.4**	**100.0**

Source. Central Bank of the Bahamas, *Quarterly Review,* December, 1978.

currency denominated instruments has been declining both in absolute terms and as a percentage of the total outstanding. It should be pointed out that one of the main factors affecting the distribution among holders of government securities in recent years has been the emergence of the national insurance scheme as a major supplier of funds to government. Almost the entire figure standing to the credit of 'public corporations' relates to the holdings of the National Insurance Board.

As a percentage of Bahamian dollar deposits government long term securities have been increasing steadily. The ratio moved from 14.3 per cent at the end of 1974 to over 17.0 per cent at the end of 1978. (See Table 2.10)

Net Foreign Assets

Under conditions prevailing in the Bahamas, it has never been easy to quantify this particular concept. Though improving, the situation is not helped by the variations in the interpretation of reporting requirements, which are by no means unrelated to the accounting systems employed. Before 1974 the term, 'net foreign assets' was simply taken to mean the difference between Bahamian dollar balances due to and due from Head Office or banks abroad by resident commercial banks. More precisely, it was a difference of the respective figures appearing against those items under the Bahamian dollar column of the reporting form. Under the present format, the concept has been expanded to embrace a wider range of transactions. The data appearing in Table 2.9 takes account of funds that have not only been converted but of accommodation extended to residents in foreign currency. The net inflow (or foreign liability) outstanding at the end of 1978 was $130.6 million.

The Liquid Assets Ratio

The Central Bank Act of 1974 authorises the Bank to institute both a 'Statutory Reserve' and a liquid assets ratio. Though what are considered to be liquid assets are clearly spelt out in the Act, at the time of writing (mid-1979), a ratio in relation to deposit liabilities was not in effect. The authorised range is between 10 and 30 per cent. We shall discuss the use of these devices as instruments of monetary control in a later chapter. There are, however, a few comments worth making at this point.

The liquid assets ratio is widely used in developing countries not so much as a tool to affect domestic credit conditions, but to encourage investments in local assets, particularly those which are considered important for developmental purposes. Eligible assets vary widely; some of the more common are cash in till, Treasury Bills, other government securities, funds held with other local institutions, balances due from abroad and reserves with the Central Bank. Some countries do not regard legal balances with the Central Bank as an eligible asset because of the fact that banks do not have access to these funds in times of difficulty. Excess reserves, of course, would qualify. Government securities would be treated in the same way if it is difficult to sell these at short notice without incurring serious capital losses. Balances from abroad tend to be included to the extent that the banks can readily repatriate these funds to meet a local liquidity problem.

An examination of Table 2.10 shows that at the end of 1978 till cash, balances with the Central Bank, Treasury Bills and other Government securities amounted to almost 30 per cent of total B$ deposits. The system showed a net debt to institutions abroad. The largest category is that con-concerning government securities other than Treasury Bills which accounted for over 17 per cent. The situation perhaps may explain the absence of a legal liquidity ratio.

'Non-Local' B$ Loans and Advances

Though this item is included in the banks' reporting form, it does not come out explicity in Table 2.9. The main reason for this is, undoubtedly, the small size of the figures ($0.3 million at the end of 1978) associated with it.

Though there appears to be no official definition of 'non-local' Bahamian dollar loans and advances, the concept seems to approximate, very closely, credit made available to entities classified as 'non-resident' (i.e. located in the country but carrying on all their activities outside the Bahamas) for exchange control purposes. Such loans denominated in Bahamian dollars, it should be noted, can only be made with the approval of the authorities. It appears, too, from interviews, that the item includes loans made to temporary residents to whom credit can be extended up to a certain amount without reference to exchange control.

Loans and Advances to Residents

The loans and advances item is, undoubtedly, the most profitable item in the banks' portfolio. At the end of 1978, total loans and advances outstanding in Bahamian dollars (including loans to Government) amounted to $213 million or to 58 per cent of total B$ assets. As indicated earlier, the bank also lends funds denominated in foreign currencies. The total outstanding (including accommodation to Government) at the end of 1978 amounted to $147 million or to 41 per cent of total domestic loans outstanding to residents.

As is the case with deposits (as we shall see later in the discussion), bank lending activities tend to be highly concentrated in a few institutions. At the end of 1978, two banks alone accounted for 54 per cent of the outstanding B$ loans and advances, while another three accounted for 31 per cent. If the banks were to be divided into clearing and non-clearing (NCBs), it would be found that while the former's share in the loans business has been increasing, there has been a corresponding decline in the share of the latter. In the period between the end of 1969 and the end of 1978, the clearing banks' proportion of total B$ loans outstanding increased from 73 per cent to 96 per cent, while that of the non-clearing group dropped from 27 per cent to 4 per cent over the same period. A similar pattern can be observed with respect to the distribution of deposits. Over the same period the clearing banks' share of total B$ deposits increased from 78 per cent to 98 per cent. There are a few main factors contributing to this trend and it is necessary briefly to mention them here. The first is that the clearing banks, by virture of the network of branches they operate, are more geared to domestic retail banking and are, therefore, able to capture an increasing share of this business. A second factor has been the withdrawal of certain institutions from the domestic market altogether, as part of organisational changes designed to bolster an increasing preoccupation with external operations which appears to have motivated their establishment in the first place. A third factor has been the closing down of at least two non-clearing banks since 1969, one of which was doing a significant amount of B$ dollar lending on the basis of currency conversion. We might point out here that this latter situation explains to a large extent the exceedingly high loans-deposit ratio prevailing before mid-1974.

The Loan/Deposit Ratio

The loan/deposit ratio is a very popular concept in analysing bank behaviour. It should be pointed out, however, that it is more useful in assessing liquidity requirements than in determining solvency for which such relationships like the capital/assets ratio and the capital/loans ratio are commonly used.

For commercial banks whose activities are normally centred on the solicitation of deposits (which provide the bulk of their funds), and the making of loans (which bring in a substantial part of their revenue), the relationship is a critical one from an operating point of view. Against the desire by the bank to maximise income from loan activities has to be balanced the need to meet short term obligations, which need is normally given priority in the interest of retaining the confidence necessary for its existence. For this reason, the loan portfolio tends to be determined after primary and secondary reserves accounts against deposits have been set up.[52] Given the fact that liquidity needs would vary from one institution to another, in practice there is not likely to be any common loan/deposit ratio, though a range of between 65 and 70 per cent is quite normal.[53] This proportion, of course, would vary from one situation to another, depending on a host of different factors. A major consideration would be the demand for bank loans and the existence of borrowers who could meet the criteria used by the banks in deciding credit worthiness. Another factor is the willingness of banks to borrow (or to convert foreign currency holdings) in order to meet credit demand in conditions where deposits are not growing at a fast enough rate. Availability of other avenues for the deployment of funds would also play a part, as can government regulations.

A glance at Table 2.10 shows that over the last two or three decades there has been a big change in the loan/deposit ratio for the banking system as a whole. The proportion increased from 17 per cent at the end of 1950 to over 70 per cent in recent years. As indicated earlier, the exceptionally high ratios in the early '70s were influenced by the operations of one particular institution which was lending, principally, on the basis of converted currency. An examination of Table 2.13 shows the proportion of B$ loans to B$ deposits vary greatly from one institution to another. On the whole, commercial banks in the Bahamas tend to maintain a high loan/deposit ratio. One explanation of this situation is, undoubtedly, the narrow range of suitable investment outlets in the Bahamas, the restrictions faced and the difficulties experienced in sending funds abroad, both in the context of the local exchange contol regulations and the uncertainty that has been characteristic of the international foreign exchange markets in recent years. Another reason is the easy access to the external currency markets where deposits can be easily purchased, thus eliminating the need for holding large amounts of liquid funds which institutions that do not enjoy this facility would be constrained to hold. In this sense, therefore, the growth of the new money markets can be said to have fundamentally affected the traditional functioning of the banks by allowing for greater flexibility in their operations and thus enhancing their profitability to the extent that this is dependent on the management of funds.

As indicated earlier, while there are official guidelines on the extent to which authorised dealers can finance local operations by foreign currency conversion, the limits imposed have often been ignored, as will be seen in the discussion on the sources of banks' funds which follows shortly.

Composition of the Loans Portfolio

In discussing the combined balance sheet of the commercial banks at the end of 1950, we observed that local assets tended to form a very small proportion of local liabilities, most of the funds being exported to Head Office and foreign money markets. The loans figure, which was seen to be the most significant item among local items, fell mainly in the 'other' category which, if we are to judge by practice in other colonial territories, comprised mainly self-liquidating credit to the foreign trade sector. Other activities benefited little, if at all, from the existence of the commercial banks which were both expatriate and externally oriented and directed.

Since then, while the evolving banking structure has remained almost totally foreign owned, the operations of the system have undergone a number of significant changes which are reflected to a large extent in the high ratio of local assets to local liabilities to which reference was made earlier in the discussion. Change can also be seen in the composition of the loans portfolio presented in Tables 2.14 and 2.15 which show the major areas in which the banking institutions have been concentrating their efforts in recent years.

A look at these tables reveals, as indicated earlier, that local lending is carried on in both Bahamian dollars and in foreign currencies, the latter operations being conducted with the permission of exchange control on a

TABLE 2.13

$B LOANS AND ADVANCES (OUTSTANDING) AS A PROPORTION OF TOTAL B$ DEPOSITS FOR INDIVIDUAL BANKS, 1974 TO 1978

(End of Year Ratios)

Banks	1974	1975	1976	1977	1978
Clearing					
1	121.6	102.8	102.8	105.6	97.9
2	120.9	118.3	94.1	106.7	100.0
3	83.6	71.4	61.0	63.2	57.7
4	78.4	73.4	61.9	63.9	101.5
5	125.4	105.5	100.6	107.5	65.6
6	114.6	83.0	70.0	73.4	74.6
7	77.9	67.3	61.6	66.6	64.7
Non-Clearing					
8	366.1	862.7	762.4	243.8	241.6
9	85.0	62.9	78.4	66.3	80.7
10	44.8	32.9	29.7	54.3	7.3
11	172.6	897.3	--	—	—
12	143.7	150.2	201.4	—	—
13	288.2	—	—	—	—
All Banks	88.0	81.0	79.3	78.9	76.7

Source: Central Bank of the Bahamas.

case by case basis. As can be seen, the total volume of such loans amount to a substantial proportion of accommodation made available in Bahamian dollars which, itself, also contains a foreign conversion element. It should be noted that the tables do not contain credit extended directly to Government. The amount of such loans outstanding increased from $4.0 million at the end of 1973 to $32.7 million at the end of 1978. Of this latter figure $27.2 million were denominated in foreign currency.

An examination of Table 2.14 shows that total loans outstanding in Bahamian dollars increased from $151.2 million at the end of 1973 to $207.7 million at the end of 1978. Loans outstanding in foreign currency on the other hand dropped from $154.6 million to $120 million over the same period. A noticeable feature of these two tables (particularly Table

TABLE 2.14

SECTORAL DISTRIBUTION (EXCLUDING GOVERNMENT) OF COMMERCIAL BANKS' B$ LOANS AND ADVANCES, 1973 TO 1978
(End of Year Outstandings)

Sector	1973		1974		1975		1976		1977		1978	
	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total
1. Agriculture & Fisheries	0.9	0.6	0.7	0.5	0.8	0.5	1.1	0.6	1.2	0.6	1.4	0.7
2. Manufacturing and Processing	3.1	2.1	1.9	1.2	1.8	1.2	2.4	1.4	0.6	0.3	0.2	0.1
3 Hotels, Clubs & Restaurants	13.0	8.6	7.7	5.1	5.8	3.7	5.8	3.3	6.0	3.2	5.2	2.5
4. Trade & Commerce	36.8	24.3	30.4	20.0	25.9	16.6	31.3	18.0	29.5	15.8	40.3	19.4
5. Utilities (Water, Electricity & Transportation)	4.8	3.2	2.9	1.9	4.2	2.7	4.4	2.6	1.0	0.5	3.4	1.6
6. Building & Construction	18.9	12.5	21.6	14.2	13.7	8.8	16.6	9.6	14.5	7.7	13.4	6.5
7. Real Estate	12.7	8.4	17.6	11.6	22.3	14.3	25.3	14.6	27.3	14.6	40.6	19.5
8. Personal Loans	29.5	19.5	33.7	22.1	37.6	24.1	41.2	23.7	52.3	27.9	53.3	25.7
9. Other Local Loans	31.5	20.8	35.6	23.4	44.0	28.1	45.4	26.2	54.9	29.3	49.9	24.0
Total	**151.2**	**100.0**	**152.1**	**100.0**	**156.1**	**100.0**	**173.5**	**100.0**	**187.3**	**100.0**	**207.7**	**100.0**

Note: Both this table and table 2.15 include loans to public corporations, but exclude credit to Government. The figures of the two tables therefore would not add up to the totals given in Table 2.9.

Source. Central Bank of the Bahamas, *Quarterly Review,* various issues.

TABLE 2.15

SECTORAL DISTRIBUTION (EXCLUDING GOVERNMENT) OF COMMERCIAL BANKS' FOREIGN CURRENCY LOANS TO RESIDENTS, 1973 TO 1978

(End of Year Figures)

Sectors	1973		1974		1975		1976		1977		1978	
	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m.	% of Total	$m	% of Total
1. Agriculture & Fisheries	0.0	0.0	0.2	0.2	–	–	0.4	0.4	–	–	0.0	0.0
2. Manufacturing and Processing	22.6	16.8	20.2	18.5	17.5	17.1	15.1	15.6	11.9	10.0	6.5	5.4
3. Hotels, Clubs & Restaurants	38.5	28.6	21.5	19.7	21.3	20.8	22.3	23.1	45.2	37.9	46.6	38.8
4 Trade & Commerce	2.2	1.6	0.7	0.6	3.2	3.1	1.4	1.4	2.8	2.3	3.9	3.3
5. Utilities (Water, Electricity & Transportation)	5.8	4.3	0.3	0.3	0.6	0.6	6.4	6.6	6.2	5.2	6.2	5.2
6. Building & Construction	21.5	15.9	19.7	18.2	22.2	21.7	21.9	22.6	21.5	18.0	22.0	18.3
7. Real Estate	36.5	27.1	28.5	26.1	21.3	20.8	10.8	11.2	7.7	6.5	13.9	11.6
8. Personal Loans	2.1	1.6	6.5	5.7	4.0	3.9	1.1	1.1	3.4	3.8	5.9	4.9
9. Other Local Loans	5.6	4.1	11.5	10.5	12.2	11.9	17.3	17.9	20.6	17.3	15.0	12.5
Total	**134 8**	**100.0**	**109.1**	**100.0**	**102.3**	**100.0**	**96.7**	**100.0**	**119.3**	**100.0**	**120.0**	**100.0**

Source: Central Bank of the Bahamas, *Quarterly Review*, various issues.

2.14 which shows the B$ loans) is the relatively insignificant volume of funds that is made available to the agricultural and manufacturing sectors. These two areas, together accounted for less than 1 per cent of B$ loans, outstanding at the end of 1978 and for 5 per cent of foreign currency outstandings. Trade and commerce still appear to take a fairly large proportion of B$ credit, accounting for over 19 per cent at the end of 1978. The real estate share of B$ loans increased from 8.4 per cent in 1973 to over 19 per cent at the end of 1978. With respect to foreign currency credit, this sector was responsible for 11.6 per cent of the total outstanding at the end of 1978. B$ loans to building and construction appear to show a declining trend in recent years, both in absolute terms and as a percentage of the total. The share of the total going to this sector dropped from 14.2 per cent at the end of 1974 to 6.5 per cent at the end of 1978. Foreign currency extensions to the building sector, though more significant than B$ credit, has also shown a tendency to stagnate in recent times. Personal loans, not surprisingly, have been increasing. Of the total $207.7 million B$ credit outstanding at the end of 1978, $53.3 million or 26 per cent (the largest category) took the form of personal accommodation. This kind of lending activity is a very profitable business and clearly the banks have been diverting an increasingly larger proportion of their funds to satisfying the demand which tends to be closely associated with the growth of income and population. The bulk of 'other local loans' category comprises funds made available to public corporations. On average, this sector accounts for over 20 per cent of outstanding B$ credit. A final point to note is that most of the loans going to the 'hotels, clubs and restaurants' take the form of foreign currency credit. At the end of 1978, 39 per cent of outstandings represented loans made to this sector as compared to only 2.5 per cent of the B$ portfolio.

Maturity Structure of Loans and Advances Outstanding

Reliable data relating to this aspect of the banks' operations are not available, and it is therefore difficult to say very much on the changes that have taken place in response to developments in local conditions. An attempt is, however, made in Table 2.16 to provide some insight into the maturity structure of loans and advances outstanding in a recent period. As can be seen there, about 33 per cent (on average) of the debit owed to the banking system in 1978 was in the form of overdrafts which seems to be a very popular form of borrowing. Another point to note is that for both the branch banks and the locally incorporated institutions, the proportion of outstanding loans due for repayment in a period exceeding 12 months was over 40 per cent. For the banking system as a whole, the proportion of loans in this category was 46 per cent. There are, of course, differences between individual banks with respect to the period of time for which loans are made, and these can be seen to some extent in the table. The various types of loans are also known to vary greatly in repayment periods. In order to make a proper assessment of the lending policies of the commercial banks we need to have a great deal more information on the original maturity of loans being made and other related data which allow little room for analysis when given in highly aggregative form.

TABLE 2.16

MATURITY STRUCTURE OF LOANS AND ADVANCES OUTSTANDING[a]

(PERCENTAGE DISTRIBUTION)

Banks	Repayable Within 12 mths.	Repayable Exceeding 12 mths.	Overdrafts	Total
Branch Banks				
1	20.1	58.4	21.5	100.0
2	10.1	65.3	24.6	100.0
3	19.6	51.8	28.6	100.0
4	9.9	76.9	13.2	100.0
5	22.3	63.5	14.2	100.0
6	22.8	18.3	58.9	100.0
All Branch Banks	18.7	46.6	34.7	100.0
Locally Inc. Banks				
7	11.4	68.8	19.8	100.0
8	75.2	11.5	13.3	100.0
9	82.3	–	17.7	100.0
10	6.4	93.1	0.5	100.0
All Locally Inc. Banks	37.8	45.3	16.9	100.0
All Banks	**21.0**	**46.4**	**32.6**	**100.0**

a: Based on average end of quarter outstandings in 1978.

Source. Central Bank of the Bahamas.

Mortgage Lending

Commercial banks got their name by virtue of the fact that originally most of their lending activities were confined to the provision of short term loans to commercial enterprises for working capital purposes. As time went on, and as the need for other types of finance increased, these institutions became increasingly involved in a wider range of accommodation extending to such areas as consumer borrowing, agriculture, real estate and so forth. Given the nature of their liabilities, however, the authorities in several countries were moved to institute regulations to govern their operations in certain areas involving long term commitments in an effort to protect depositors. In the United States, for example, the amount of funds allocated to real estate mortgage loans cannot exceed 45 per cent of the total of individual time and passbook savings accounts.[54] In addition, there are also limits placed on maturities and on the amount of the loan in relation to the value of the property concerned. Even in countries where there are no statutory constraints placed on banks, it is clear that they cannot afford to operate without house rules of their own, formulated on the basis of liquidity requirements relating to deposit withdrawals and other short term commitments and on the need to minimise risks. The extent to which many banks engage in long term lending is very often dependent on the funds available after primary and secondary reserves needs have been met and on the volume of shareholders' resources at their disposal.

Mortgage lending by commercial banks in the Bahamas is a relatively new aspect of their operations, dating back no earlier than the mid-1960s when the demand for this type of loan began to assume enormous proportions. Until 1953 when the Finance Corporation of the Bahamas Limited (FINCO) was established to provide mortgages on a long term basis, most mortgages available in the Bahamas were mainly for one year, subject to call at any time after that period.[55] The funds "were almost entirely under the control of lawyers whose wealthy clients, principally from the U.K., provided mortgaging and financing here to escape the high death duty rates on real estate held outside the U.K. and to circumvent any capital gains taxes should they be introduced in the U.K."[56] The closing off of this source in 1962 when the British Government passed legislation eliminating all death duty exemptions on foreign real estate held by U.K. residents, left the local mortgage field almost entirely in the hands of FINCO and some local private lenders. Subsequently, other finance companies and the commercial banks were to become more deeply involved. The latter's main concern up to the middle '60s and even for some time after that was the making of short term (less than two years) loans for business and personal purposes. Some of them were also prepared to advance interim finance upon production of a letter of intent from a responsible mortgage lender while details were being worked out.

From Tables 2.13 and 2.14 it is not possible to say how much of the banks' outstanding funds were invested in mortgages. However, if we were to take categories 7 and 8 as a rough indication, at the end of 1978 the proportion was 26 per cent of total Bahamian dollar loans and advances and 30 per cent of foreign currencies extension, giving a total of 27 per cent of all outstandings. Translated in volume terms, this would amount to 54.0 million denominated in Bahamian dollars and 35.9 million, denominated in foreign currencies, making a total of $89.9 million. Outstanding Bahamian dollar loans and advances to the 'Building and Construction' and 'Real Estate' sectors at the end of 1978 amounted to 20 per cent of total B$ deposits. (See Table 2.17).

An examination of Table 2.17 shows that the participation of commercial banks in mortgage activities (bearing in mind our earlier assumption) varies widely from bank to bank. One institution alone was holding 70 per cent of the B$ loans and advances outstanding to the 'Building and Construction' sector at the end of 1978. Two were responsible for more than half of the funds extended for real estate purchase or development. The priority which the banks attach to mortgage lending clearly differs a great deal from one institution to another. This is particularly apparent from columns (3) and (4) which show mortgage loans as a proportion of their respective loans portfolio and of deposits. Though it does not come out clearly in Table 2.17, there are important deposit taking banks which do very little mortgage lending. It should be pointed out, however, that there is one institution which is involved in this activity through a subsidiary specifically set up for this purpose.

As indicated earlier, the interest of commercial banks was for a long time centred on providing short term finance to borrowers who were able to meet the creditworthy criteria of the banks, or who could provide acceptable collateral. To a large extent, this is still true, though in recent years, the criteria standards have probably fallen as a result of being forced to employ locally generated resources in the domestic economy and the tendency to diversify their lending activities, either voluntarily, in an effort to increase profits, or under pressure to contribute to the social objectives of the communities in which they operate. One area in which banks are increasingly being pressed to contribute, particularly in developing countries with their rapidly growing populations and inadequate financial facilities, is housing — the shortage of which ranks among the foremost problems confronting many governments of the day. While in some instances banking institutions have responded by providing finance to middle and upper income groups who are able to provide the necessary security for such loans, the lower classes, where assistance is most needed, are unable to qualify as recipients for conventional loans. To deal with this problem in the Bahamas, the United Bahamian Party (UBP) Government, in order to provide some incentives to lenders, passed legislation in 1961 guaranteeing loans up to $14,000 of construction cost, repayable over a maximum period of 15 years. The response to this law by the financial system was clearly not encouraging, and in 1967, during the very first year of the Progressive Liberal Party (PLP) administration, a new Act was adopted increasing the loan limit to $28,600 (now $38,600) and extending the repayment period to 25 years. By 1970 there was still no marked improvement in the situation and, in a booklet addressed to his Party's convention of that year, Mr. Pindling freely admitted that

> *"by far the most pressing social problem and potentially the most explosive, is the problem of housing. Despite our efforts to date we have not yet touched the problem of decently housing the mass of*

TABLE 2.17

PARTICIPATION OF COMMERCIAL BANKS IN MORTGAGE LENDING [a]

Banks	(1) Dist. of Total[b] 'Building and Construction' Loans Outstand. $ m	%	(2) % of Dist. of Total[b] 'Real Estate' Loans Outstanding $	%	(3) B$ Loans in (1) and (2) As a % of Total B$ Loans	(4) B$ Loans in (1) and (2) As a % of Total B$ Deposits
1	1.1	3.2	1.6	2.9	10.0	9.8
2	4.4	12.5	15.7	28.8	37.6	37.9
3	3.4	9.5	1.6	3.0	20.7	11.9
4	0.4	1.2	14.1	25.8	52.0	52.8
5	0.8	2.2	4.4	8.0	14.4	9.5
6	–	–	7.2	13.2	17.0	12.7
7	24.8	70.1	6.0	11.1	15.7	10.1
8	0.1	0.3	3.1	5.6	38.3	92.6
9	–	–	0.8	1.5	47.0	37.9
10	0.4	1.0	–	0.0	–	–
All Banks	**35.4**	**100.0**	**54.5**	**100.0**	**26.0**	**19.9**

a: Based on loans outstanding at the end of 1978.

b: Local and Foreign currency.

Source: Central Bank of the Bahamas.

Bahamian people. This is because something like 60 per cent of the people who apply for houses at the Department of Housing cannot qualify financially for a conventional bank loan. It is now patently clear that the banks and insurance companies operating in the Bahamas are unwilling to finance mass low-cost housing, and private developers are not interested because such a scheme is not profitable enough.[57]"

Besides the policy of providing 100 per cent guarantee on loans to borrowers who have the land, a complementary approach to solving the housing problem has been the construction of low cost houses, initially financed by the government and intended for people in the lowest income groups who have no security on which to negotiate money from the banks. Towards this end, a number of institutions[58] have, in recent years, provided funds to government which is still clearly unable to satisfy all the housing needs of the community.

An Appraisal of the Housing Act

In a communication to the House of Assembly in 1975, the Prime Minister, Mr. Lynden Pindling, was moved to make the following statement as part of a larger announcement giving details on a programme designed to stimulate the economy:

> *Honourable Members are aware that the government is deeply concerned about adequate housing for families in the lower income bracket, that is, families with a total income of $10,000 per annum or less. When we realise that some 24 per cent of Bahamian families earn between $2,000 and $5,000 per year, we appreciate that the lower income bracket constitutes the majority of the people of the Bahamas. Of course, the government is not unmindful of the needs of the Bahamians in the middle income bracket and it will be seen that measures which are being taken will assist them also, but the real problem lies in the low income bracket. Unfortunately, our commercial and profit-oriented society in the Bahamas has not, to date, been able to meet the needs of the mass of the people for adequate housing.*[59]

From discussions with certain financial institution in the Bahamas, a number of points relating to the problems of mortgage lending in this country have emerged. Generally, it is argued that low income earners are high risk borrowers who are the first to be affected in a downturn, and thus their ability to repay the loan suffers. Even though the latter may be guaranteed by the Government, it may take considerable time to recover the unpaid portion of the facility from the Public Treasury, and this tends to act as a disincentive to potential lenders. A second point that has been made is that the making of loans within the framework of the Housing Act is an unprofitable business. Besides the large amount of paper work involved, the interest rates cannot be adjusted to take account of changing conditions, as is the case of other loans.

Despite Government's good intentions, a fundamental factor with which the present administration has apparently not been able to come to grips is that there is a large number of people in the Bahamas in need of proper housing who cannot afford to make repayments on a loan on the basis of their present wages or salaries. While lengthening the existing period of repayment may be of assistance to a few, for the majority better housing conditions are only possible with a new approach in which Government will, of necessity, have to play a larger and more active role. Given the revenue constraints on the latter, the dilemma and concern which it feels become readily apparent.

LIABILITIES STRUCTURE OF COMMERCIAL BANKS

As indicated in the previous section dealing with the assets portfolio of the commercial banks, the banks' balance sheet as published in the CBB's Quarterly Review is an adjusted and summary statement net of inter-bank deposit and borrowing accounts.[60] The liabilities figures also include foreign currency deposits held by residents, as well as capital paid-up in foreign currency. As can be seen in Table 2.18, deposits held by the government (including state bodies) and the public form the largest item in the banks' liabilities structure. Borrowing from the Central Bank has been negligible. Balance due to other local financial institutions has, on average, accounted for less than 3 per cent of total liabilities. Capital and surplus accounts have, in recent years, contributed less than 10 per cent to total liabilities. In view of this structure, the analysis that follows will be comprised, essentially, of two parts. In the first section we shall give a broad indication of the main sources of bank funds, and in the second we shall undertake a more elaborate discussion on the growth and trends in banks' deposits which provide the bulk of their resources for lending and investment purposes.

Sources of Banks' Funds

It is generally known that equity capital is not the only or even the major source of funds for a commercial bank which tends to derive a significant proportion (in some circumstances all) of its resources from the idle balances of other individuals, corporations and institutions. In addition to these two sources (equity and deposits), resort can also be had to the surplus and undivided profits of the bank, where these exist, and to borrowing which can take a number of forms, depending on the nature of requirements at any particular time. A further source of lending which is a unique attribute of banking operations is the monetisation of credit or what is sometimes called 'derivative deposits'. These come into being through an age-old principle which allows the bank to credit a borrower's current account with

TABLE 2.18

PERCENTAGE COMPOSITION OF THE PUBLISHED BALANCE SHEET (LIABILITIES) OF COMMERCIAL BANKS, 1973 TO 1978

(End of Period)

	Items	1973	1974	1975	1976	1977	1978
1	Total Deposits (Govt. and Public)	74.2	85.1	92.5	82.3	83.4	84.9
2.	Due to Central Bank	–	–	–	–	–	–
3.	Balance due to Other Local Financial Instits.	3.8	1.3	2.1	2.2	2.0	1.2
4	Capital and Surplus	18.9	7.6	9.5	9.3	8.0	9.7
5.	Other Liabilities	3.1	6.0	5.9	6.2	6.6	4.2
	Total Liabilities	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Central Bank of the Bahamas, *Quarterly Review,* various issues.

the amount desired without the surrender of any resources on his part, as happens when a 'primary deposit' is created. While the process by which both types of deposits come into being have different policy implications, in practice both are functionally indistinguishable.

From what we have said, it is clear that a banking operation which consists essentially of soliciting the savings of others and then re-lending these to interested borrowers can be carried without any funds being put up by the people involved in such a venture.[61] As is well known, this type of operation has been widely used in developing countries in the form of the branch bank system, first introduced by metropolitan institutions in expanding their overseas network.

In the Bahamas, as we have noted earlier, domestic banking is largely carried on by the branches of international concerns having their head office located in foreign centres. At the end of 1978, 92 per cent of Bahamian dollar deposits were held by such banks. Based on average end of quarter balances in 1978, it can be seen in Table 2.19 that over 50 per cent of the deposit funds held by these institutions were derived from the lower end (demand and savings accounts) of the cost spectrum. Of the time deposits outstanding, almost all were in the category having a less than 12-month maturity. Each bank, as can be seen, tends to have its own policy,

TABLE 2.19

SOURCES OF FUNDS[a] FOR INDIVIDUAL COMMERCIAL BANKS (PERCENTAGES)

Banks	Equity Capital	DEPOSITS				Total
				Time		
		Demand	Savings	Less Than 12 Months	More Than 12 Months	
Branch Banks						
1	–	23.1	24.8	52.1	–	100.0
2	–	36.0	26.9	37.1	–	100.0
3	–	26.3	22.8	50.5	0.4	100.0
4	–	31.6	13.7	54.7	–	100.0
5	–	35.6	7.8	56.6	–	100.0
6	–	32.8	28.8	38.3	0.1	100.0
All Branch Banks[b]	–	**30.6**	**25.1**	**44.2**	**0.1**	**100.0**
Locally Inc. Banks						
7	17.7	16.7	12.4	53.2	–	100.0
8	73.8	10.6	1.8	13.8	–	100.0
9	20.4	10.4	20.0	49.2	–	100.0
10	85.4	3.7	–	10.9	–	100.0
All Locally Inc. Banks	**43.9**	**13.0**	**8.1**	**35.0**	–	**100.0**

a: Based on average end of quarter balances, 1978.

b: On average these banks taken together account for about 90 per cent of the B$ deposits.

Source: Central Bank of the Bahamas.

and this is reflected in the type of deposits which it sets out to attract. There are certain institutions (particularly the one-office banks), for example, which find it easier (and perhaps cheaper) to manage a few large fixed deposit accounts than several small accounts of the demand and savings variety.

The paid-up capital (a porportion of which is in foreign currency) of the locally incorporated banks is related more to the overwhelming foreign business of these banks than to their domestic operations, it would therefore be misleading to some extent to view capital resources in relative terms vis-a-vis deposits as sources of funds. Furthermore, capital in some instances have little to do with banking activities as such. In the case of one bank which (up to the mid-1970's) accounted for a substantial proportion of the total equity capital of the sector, resources derived through this medium were largely used to support the operations of subsidiary or affiliated companies engaged in non-banking financial activities. In the balance sheet of this bank, items 'due to' and 'due from' associated companies tended to take on fairly significant proportions, very often surpassing the magnitude of the figures directly related to its banking operations. For these reasons, Table 2.19 which presents data relating to the branch banks (these account for the bulk of the Bahamian dollar banking business) and the locally incorporated institutions in separate categories, gives a much better indication of the main sources of banks' funds than Table 2.20 which gives an aggregate picture for the system as a whole which, to some extent, is distorted by the character of the non-clearing banks. The declining position of equity capital in the latter table is due largely to the complete withdrawal of certain institutions from the local market and the closing down of at least two others in recent years. In certain cases there have been organisational changes designed to separate the Bahamian dollar business from foreign activities.

Before going on to discuss the question of currency conversion as a source of funds, a word should be said on the local inter-bank market which is a derivative, rather than a primary source. As indicated earlier, this facility is used by the banks to adjust their cash and liquid balance positions rather than as a direct base for lending for which the funds are much too volatile, being placed for very short periods by institutions with excess liquidity. From time to time, however, some banks do take long term deposits or borrow from other banks within the system to support their lending activities.

Foreign Currency Conversion

From our discussions in previous sections, it is clear that access to foreign currency resources by financial institutions in the Bahamas is no great problem, many of them being engaged in the Euro-currency markets and in business directly involved with handling of foreign monies. The extent to which they are permitted to convert foreign exchange to the local medium to conduct domestic activities, however, is governed by the exchange control regulations of the country, which prescribes maximum borrowing limits from time to time. The existing restriction is half a million Bahamian dollars. If this regulation were to be obeyed to the letter, the total foreign currency conversion to Bahamian dollars (and vice versa) for the banking system as a whole could not at any time exceed the number of authorised dealers multiplied by the half a million dollar limit. Figures published by the Central Bank, however, indicate that the regulation is

TABLE 2.20

SOURCES OF FUNDS FOR THE BANKING SYSTEM, 1969 TO 1978
(PERCENTAGES)

End of Period	Equity Capital	Deposits			Total
		Demand	Savings	Time	
1969	13.3	34.9	20.8	31.0	100.0
1970	16.7	33.2	22.0	28.1	100.0
1971	18.4	28.6	23.0	30.0	100.0
1972	17.2	32.7	22.3	27.8	100.0
1973	16.2	32.0	23.6	28.2	100.0
1974	8.9	30.8	24.0	36.3	100.0
1975	8.1	27.8	21.3	42.8	100.0
1976	7.3	24.3	21.0	47.4	100.0
1977	6.7	26.4	21.4	45.7	100.0
1978	5.9	28.3	23.1	42.7	100.0

Source: Central Bank of the Bahamas.

often disregarded, some banks apparently being more guilty than others in overstepping the limits. In 1973, for instance, while the total limit was around $7 million, the net foreign currency position (i.e. foreign money converted to local dollars) averaged over $33 million. This may have been due to some peculiar circumstances which apparently no longer obtain. Since 1974 the figure has been considerably reduced.

What needs to be pointed out, however, is that the extent of resort to this facility varies from bank to bank, depending on the demands being made on the particular institution and the availability of foreign funds. The incentive factor stems from the relative returns to be gained from lending Bahamian dollars, taking into account the attendant risks and costs involved in the exchange transaction. The financing of domestic activities, through this medium, does have implications for monetary policy, particularly in periods of tight money when a curb on local lending may be the object of the authorities seeking to restrict inflation and/or protect the country's balance of payments position. However, in view of the essentially short term nature of the funds flowing through the banking system and the absence of monetary policy, the main concern up to now has been with the possible direct impact on reserves arising from a sudden outflow of such resources (which can be quite unpredictable) at a time when the country can least afford it.

Growth of Bank Deposits

As indicated earlier, an overwhelming proportion of the banking system's assets and liabilities are in foreign currencies, particularly U.S. dollars. At the end of 1978 only 6 per cent of total deposit liabilities was in Bahamian dollars as compared to 9 per cent at the end of 1969. The percentage varies from year to year with the level of external business which can fluctuate in large amounts over very short periods.

A discussion of the foreign operations of the banking system and their possible implications for the local economy will be reserved for a later section. At this point attention is confined to an examination of Bahamian business of the commercial banks.

A prominent feature of the system is that domestic banking activities are highly concentrated in the older international branch banks which were established before 1960. At the end of 1978, out of a total of $272 million in deposits outstanding, $245 million or 90 per cent were held by five banks. The clearing banks, as a group, were responsible for over 95 per cent of Bahamian dollar deposits. It should be pointed out that the level of participation in the Bahamian dollar market does not necessarily give an indication of the relative size of the respective banks, in terms of total assets, since an overwhelming proportion of the latter aggregate, as pointed out earlier, comprises foreign currencies related to their external operations.

The share of deposits held by each bank tend to correspond broadly with the proportion of total branches operated by individual banks. For some banks, however, because of branch location, longer establishment and, perhaps, better marketing, the share of total deposits received tends to exceed their contribution to the total number of branches in operation, while for others the reverse situation obtains. This can be seen in Table 2.21 which sets out in a semi-aggregative form the proportion of total deposits held in relation to the number of branches maintained.

Composition of Bank Deposits

The two decades between 1950 and 1970 witnessed a tremendous increase in the value of certain monetary assets in the Bahamas. At the end of 1970, the volume of the local note issue stood at $23.8 million which was more than twelve times the value of the corresponding figure in 1950. Banks' liabilities to the public also rose sharply in this period, increasing by over 500 per cent. Another medium which has taken on in-

TABLE 2.21

CLEARING BANKS: BRANCHES OPERATED[a] IN RELATION TO DEPOSITS HELD (AT END OF 1978)

No. of Banks	No. of Branches[b] Operated	Proportion of Total No. of Branches	Proportion of Total Deposits[c]
2	27	52.0	55.6
2	15	28.8	28.2
3	10	19.2	15.2
7	**52**	**100.0**	**100.0**

a: At 30 June, 1979

b: Including sub-branches.

c: Held by clearing banks.

Source: Central Bank of the Bahamas.

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creasing importance in recent years (as we shall see in Chapter 3) is the growth of insurance instruments in the economy. Compared to these, however, the growth of other financial assets of particular interest to individuals has been relatively insignificant. There is no local Stock Exchange and the volume of corporate securities currently traded is extremely small and is likely to remain so, unless more deliberate measures are adopted with a view to increasing Bahamian participation in various sectors of the economy. Treasury Bills of 90-day duration which have been par of the government's financial process since the early '60s and which are mainly held by institutional lenders stood at $14.0 million at the end of 1978. This was equivalent to 5 per cent of total bank deposit liabilities at the time. A more recent innovation has been the issue of medium and long term securities by the government in its efforts to raise development funds. At the end of 1978, the amount outstanding in Bahamian dollars stood at $114.0 million, as compared to $23.8 million at the end of 1974.

It can be seen, therefore, from this brief outline that with the growth of income there has been no concomitant development of the financial markets which remain at a level associated with those of the poorest countries. As a consequence, domestic savings have tended to flow largely through the commercial banks which remain the largest mobilisers of financial resources in the economic system. The obligations of the banking sector are almost wholly of non-marketable forms.

In the following paragraphs we discuss, briefly, the evolution of bank deposits and some of the related developments which have taken place in domestic retail banking activities.

Table 2.22 presents the growth of the various types of bank deposits over the period 1950 to 1978. Here, it can be observed that while all categories of deposits have grown, there has been a great divergence in the rate of expansion of each group. Between 1950 and 1970 demand deposits (in current dollars) increased more than three times, savings deposits almost ten times and time deposits 46 times. As a result of this uneven growth rate, the demand deposits in total deposits which stood at over 75 per cent in 1950 dropped to 40 per cent at the end of 1969 and have shown a tendency to decline since. Both savings and time deposits have increased their respective share over the years, with the latter showing a more definite upward trend. As far as developments during the 1970s are concerned, the data for the very early part of the decade appear to contain a large margin of error. It is therefore difficult to draw firm conclusions from a comparison with the later years. Table 2.23 uses 1973 as a base to measure the growth of the various types of deposits in recent years. It can be observed here that time deposits continue to outstrip the other categories, the demand group experiencing the lowest expansion rate. Overall, total deposits grew by 73 per cent between 1973 and the end of 1978. As we shall see later, these recent trends persist in the face of a stagnant deposit interest rate structure during the '70s.

The general pattern described above is not significantly affected even when the so-called 'non-local' Bahamian dollar deposits (which are included in the figures in Table 2.22) are taken into account. However, as can be clearly seen from the magnitude of the figures presented in Table 2.24 (which also shows the composition of these liabilities) they did have some impact on the overall totals, particularly until the late '60s/early '70s when a declining trend appears to have set in. The total decreased from a high of $27.2 million at the end of September, 1969 to $5.9 million at the end of September, 1973, and according to predictions, should have continued declining. Instead, we see a slight tendency for it to increase in recent years. What is also noticeable is that, whereas the larger share of 'non-local' deposits were held in the form of fixed accounts in earlier years, the figures for recent years seem to indicate that there has been a shift to demand deposits which now form the largest single category. For purposes of the money supply, this may have some implication, but, we shall return to this question at a later stage.

So far we have been discussing 'non-local' deposits without defining the term or saying anything about the process by which these liabilities arise. Essentially, the concept applies to a Bahamian dollar deposit held by an individual or entity classified as 'non-resident' for exchange control purposes. Such deposits, it appears, can come about in a number of ways. It seems from discussions with various people that some 'non-local' accounts

TABLE 2.22

COMMERCIAL BANKS' DEPOSITS BY TYPE, 1950 TO 1978

End of Period	(1) Total B$ Deposits $ m.	(2) Demand Deposits $ m.	(3) (2) as a % of (1)	(4) Savings Deposits $ m.	(5) (4)as a % of (1)	(6) Fixed Deposits $ m.	(7) (6) as a % of (1)
1950	25.2	19.6	77.7	4.4	17.5	1.2	4.8
1969	182.0	73.3	40.3	43.6	23.9	65.1	35.8
1970	164.0	65.2	39.8	43.5	26.5	55.3	33.7
1971	164.4	54.5	33.2	44.9	27.3	65.0	39.5
1972	170.9	63.8	37.3	44.9	26.3	62.2	36.4
1973	152.3	56.9	37.4	43.7	28.7	51.7	33.9
1974	173.0	58.6	33.9	45.6	26.3	68.8	39.8
1975	192.6	58.1	30.1	44.7	23.2	89.8	46.6
1976	215.5	56.5	26.2	48.8	22.7	110.2	51.1
1977	238.2	66.8	28.0	54.6	22.9	116.8	49.0
1978	271.5	81.7	30.1	66.5	24.5	123.3	45.4

Note. Since the introduction of the new reporting forms in 1973, the figures for subsequent years give a more accurate picture of the deposit situation than those for the period between 1969 and 1972.

Source: Central Bank of the Bahamas.

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are remnants from a previous era when there were large numbers of foreigners working and living in the Bahamas. On their return home many of them (particularly those who held property in the country) chose not to withdraw their money, meeting local expenses by making payments out of these accounts, many of which have not been replenished with the passage of time – hence the reason for the decline in the total amount (see Table 2.24). A second and important source (for which the term 'non-local' B$ deposits was originally intended to apply) arises from an entry in the banks' books on the basis of instructions from offices abroad to take a deposit in a foreign currency and hold it in Bahamian dollars.[62] The transaction which is entirely external in nature (since it does not involve

TABLE 2.23

GROWTH INDEX OF BANK DEPOSITS (1950 = 100 AND 1973 = 100)

End of Period	Demand Deposits	Savings Deposits	Time Deposits	Total Deposits
1950	100.0	100.0	100.0	100.0
1970	332.6	988.6	4,608.3	650.7
1973	100.0	100.0	100.0	100.0
1974	102.9	104.3	133.1	113.8
1975	102.1	102.2	173.7	126.5
1976	0.99	111.7	213.1	141.5
1977	117.4	124.9	225.9	156.4
1978	143.6	152.2	238.5	178.3

Source: Table 2.22.

the surrender of foreign currency to the local authorities) results in the creation of a B$ deposit, repayable in a foreign medium. According to Payton,[63] the banks had agreed to his suggestion made in 1968 (with the approval of the Minister of Finance) to retain any new external deposits of the kind just described, in the currencies in which they were received. They had also undertaken to run down the existing non-resident owned deposits by turning them back into external currency deposits as the opportunity occurred. If the banks have in fact adhered to this agreement, this factor may account for part of the decline referred to earlier. During the late sixties/early seventies, some financial institutions tended to use very arbitrary definitions of a non-local Bahamian dollar deposit.[64] In more recent times, much of the confusion has disappeared since the term now generally refers to Bahamian dollar accounts held by summer residents. These accounts are fed by foreign currency.

The growth pattern, discussed above, with respect to total B$ deposits can be explained to a large extent by the financial environment we discussed earlier, in which income growth was seen to be taking place without any parellel expansion in the range of earning assets, particularly those

TABLE 2.24

THE STRUCTURE OF 'NON-LOCAL' BAHAMIAN DOLLAR DEPOSITS, 1969 – 1978

	Demand		Saving		Fixed		Total	
End of Period	$m.	% of Total	$m	% of Total	$m.	% of Total	$m.	% of Total
1969	8.0	31.6	2.0	7.9	15.3	60.5	25.3	100.0
1970	4.6	25.6	1.9	10.7	11.4	63.7	17.9	100.0
1971	2.7	26.5	0.9	8.8	6.6	64.7	10.2	100.0
1972	3.7	45.7	0.8	9.9	3.6	44.4	8.1	100.0
1973	4.1	53.2	1.6	20.8	2.0	26.0	7.7	100.0
1974	2.3	52.3	0.2	4.5	1.9	43.2	4.4	100.0
1975	1.7	36.2	1.0	21.3	2.0	42.5	4.7	100.0
1976	2.7	36.0	1.8	24.0	3.0	40.0	7.5	100.0
1977	4.0	70.2	0.5	8.8	1.2	21.0	5.7	100.0
1978	4.2	73.7	0.2	3.5	1.3	22.8	5.7	100.0

Source: Central Bank of the Bahamas.

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desired by individuals. There have undoubedly been, however, a number of other factors related to the attitudinal changes of wealth holders and developments in the payments mechanism and associated banking techniques which have contributed to the relatively slower growth of demand deposits. Since the latter (as we shall see later) forms a large component of the money supply (currency in circulation plus private demand deposits) an increasing ratio between nominal GNP and the stock of money or the income velocity of money[65] (see Table 2.25) would seem to imply an increasingly more efficient use of money, which, no doubt, is due in part to the adoption of better cash management techniques designed to maximise returns from available funds.

Rationalisation of the growth of savings and time deposits would seem to revolve largely around the developing institutional framework and the emergence of an income conscious community, increasingly inclined to

TABLE 2.25

MOVEMENTS IN INCOME VELOCITY,[a] 1969 TO 1977

Years	Income Velocity[a] of Narrow Money, M_1	Income Velocity[b] of Broad Money, M_2
1969	4.2	2.0
1970	4.6	2.2
1971	5.6	2.3
1972	5.4	2.2
1973	6.4	3.0
1974	8.0	3.2
1975	8.3	3.0
1976	9.2	3.0
1977	9.3	2.6

a: GNP (at market prices) divided by M_1 (currency in circulation plus B$ demand deposits held by the private sector).

b: GNP (at market prices) divided by M_2 (M_1 plus Bahamian dollar savings and time deposit liabilities of the commercial banks).

Sources:. Table 1.4; Central Bank of the Bahamas, *Quarterly Review*, various issues.

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minimise the costs emanating out of any constrained portfolio choice. While the banks compete for demand deposits, no explicit income (by agreement) is paid on these funds. The tendency under this condition would, therefore, be towards the holding of minimum demand balances related largely to liquidity requirements, which incidentally, can also be met out of savings accounts,[66] since, in practice, withdrawals from the latter are widely permitted without prior notice. Savings accounts, therefore, not only pay interest but can also be used to some extent as demand accounts, and this attribute is, undoubtedly, their major attraction. The phenomenal expansion of time accounts, which are less liquid than either demand or savings deposits, reflects the increasing availability of funds seeking short term investment opportunities. The response of the banks to this situation is seen in the wide variety of plans offered, which not only vary in the length of time for which the funds are taken, but also in amounts they are prepared to accept. There are some banks (particularly the 'unit' institutions) which will not take deposits below certain limits. In most cases the interest rates paid tend to vary with the maturity period of the deposit and the size of the sum involved.

This rapid expansion in bank deposits has been the outcome of two main phenomena, both previously described. One was the exceptional increase in income since the 1950s and the other was the equally remarkable growth of banking facilities and the consequent impact on the development of the banking habit. As seen in Table 2.1, the number of banking offices increased from four in 1950 to over 60 in 1970. With respect to the location of the offices operated by the clearing banks, Table 2.26 shows the distribution of islands in a recent period. As can be seen, more than half of the total number of branches is concentrated in New Providence which contains about 60 per cent of the total population of the Bahamas and which, with Grand Bahama, account for the bulk of all activities taking place in the country. Even when we exclude the three non-clearing banks (which maintain one main office each) and the People's Penny Savings Bank (which has three branches), the number of persons served per branch comes out to be quite small, averaging about 4,500.[67] This makes the Bahamas, undoubtedly, the most intensely banked country in the region.[68]

Bank Deposits in the Money Supply

In an earlier section the growth of the various types of bank deposits and their evolution over a limited time span (for which data was available) was examined. In the following paragraphs a brief look is taken at the expansion of deposits in relation to currency supply over the same period and an attempt made to rationalise the particular relationships which have been developed, and to examine some of their broader implications in the context of the evolving financial and institutional structure. At the same time, it is hoped to discuss some of the specific problems involved in formulating a money stock concept in the peculiar economic environment of the Bahamas.

While it is now generally agreed that certain forms of bank deposits perform the functions of money and, therefore, should be included in any definition of the money supply, there is still a great deal of controversy on the question of whether other kinds of bank liabilities and, even the liabilities of certain other financial institutions should be so treated. There cannot, of course, be any fixed or universal definition of the money stock aggregate, since customs and financial practices vary from country to country and even over time. The problem facing the authorities of a country at any particular moment, it seems, is to derive a definition that has opera-

TABLE 2.26

LOCATION (BY ISLANDS) OF BRANCHES[a] OPERATED BY THE SEVEN CLEARING BANKS
(at 30 June, 1979)

	Islands									
	New Providence	Grand Bahama	Andros	Eleuthera	Abaco	Exuma	Bimini	Long Island	Other Islands	Total
Canadian Imperial Bank of Comerce	4	3			2					9
Barclays Bank	3	1		1	1					6
Chase Manhattan Bank	3	1		1						5
Bank of Nova Scotia	7	1			1	1		1		11
Bank of Montreal (Bahamas and Caribbean Ltd)	2	1								3
Citibank	1	1								2
Royal Bank of Canada	8	1	2				1	1	3	16
Total	**28**	**9**	**2**	**2**	**4**	**1**	**1**	**1**	**3**	**52**

a Includes sub-branches but excludes agencies, of which there were seven

Source: Central Bank of the Bahamas.

tional significance within the framework of priorities and objectives which they seek to implement and attain at any given time, taking into account institutional and other constraints that can influence the net effect of any particular policy chosen. Even here the question of empirical guidance is not irrelevent. Cagan has rightly pointed out that conjectures "on the characteristics of 'money' do not help much, because the important consideration is market behaviour, particularly the cross elasticities of demand between the various assets with respect to their comparative rates of return '.[69]

In its early statistical publications,[70] the Central Bank of the Bahamas tended to use two concepts of the money supply, based exclusively on its own liabilities and those of the commercial banking sector. The first, called M_1 comprised currency in circulation and total demand deposits. Subsequently, the latter aggregate was adjusted to exclude government-owned funds. The second definition, termed M_2, was made up of M_1 plus banks' savings and time deposits. Recent issues of the Bank's *Quarterly Review* show a new approach to the supply of money without apparently offering any theoretical foundation to the statistical framework embraced. M_1 and M_2 remain more or less the same, except that demand deposits held by the Central Bank are now included in the definitions. Alongside these two concepts is juxtaposed a third category called M_3. This comprises M_2 plus deposits held by other local financial institutions plus foreign currency deposits held by residents. The main idea behind this format, it seems, is to give some indication of the potential money stock rather than to offer an official explanation of what assets should be included in a definition of money supply in the Bahamas context. For a number of reasons, defining what constitutes money in the Bahamas is not a particularly simple matter from a policy point of view, and some of these are briefly outlined in the following paragraphs.

One of the general issues relating to a definition of the money supply was cited earlier. In addition, there are a number of unusual practices which are somewhat specific to the Bahamas situation and which cannot safely be ignored in formulating a model on which to base policy decisions. There are three questions which need to be considered in the context of our discussion: (i) Foreign currency in circulation; (ii) Foreign currency deposits held by residents; and (iii) Bahamian dollar deposits owned by non-residents.

In terms of the first issue, United States currency has traditionally circulated side by side with the local medium even though there has never been a legal sanction[71] for this practice which is obviously very closely related to the tourist trade and the physical proximity of the two countries. While no satisfactory means has yet been devised for ascertaining the volume of such currency in circulation at any one time, some estimates based on a study of tourist expenditure by the Ministry of Tourism were made for 1970 and 1971. These are presented in Table 2.27 which also shows comparative figures relating to local currency in circulation. On average U.S.

TABLE 2.27

VOLUME[a] OF U.S. AND BAHAMIAN CURRENCY IN CIRCULATION, 1970 and 1971

B$'000 End of Period	1970 U.S. Currency in Circulation[a] (1)	 Local Currency in Circulation (2)	 (1) as a % of (2) (3)	1971 U S. Currency in Circulation[a] (1)	 Local Currency in Circulation (2)	 (1) as a % of (2) (3)
January	896	24,707	3.6	926	22,907	4.0
February	955	23,995	4.0	1,067	22,397	4.0
March	1,182	24,173	4.9	1,125	22,485	5.0
April	932	24,633	3.8	1,244	22,464	5.5
May	980	24,827	3.9	1,022	22,623	4.5
June	929	24,047	3.9	1,009	22,149	4.5
July	1,090	23,806	4.6	1,284	21,871	5.9
August	1,098	23,683	4.6	1,284	21,641	5.9
September	651	23,901	2.7	644	21,179	3.0
October	649	23,660	2.7	840	21,077	4.0
November	787	23,444	3.3	955	20,979	4.5
December	869	25,713	3.4	970	24,988	3.9

a: Estimates are based on the assumption "that leakage from circulation in any period is roughly equivalent to the amount injected in the previous period".

Source: *Statistical Review of Money and Banking,* various issues (no longer published) dollars would seem to form less than 5 per cent of the local currency in circulation at any one time.

While the law requires that residents who come into possession of foreign money should surrender such currencies to the authorised dealers, in practice it appears that at the retail level this is not widely done, since a large part of current transactions are conducted in U.S. currency which circulates freely on par with the local money. Given the wide acceptability of the American dollar and the regular flow of large numbers of tourists from the mainland, enforcement of the regulations is not a particularly easy matter, and the authorities up to now have been content to go along with tradition, or at least have not felt the need to curb the practice, though the amount of U.S. currency in circulation at any one time has clearly been increasing with the growth of the tourist trade.

There are two consequences deriving from this situation which may eventually lead to some concern, and which need only be mentioned here. One is the price effect resulting from the inability of the authorities to control the total amount of money in circulation; and the other is the inherent potential for defrauding the country of legitimate foreign exchange earnings by unscrupulous persons. As for the first problem, foreign currency in circulation has, so far, apparently not been of a volume sufficient to pose any serious treat to the price level. As far as the second is concerned, the lack of attention can no doubt be attributed to the ready availability of foreign exchange resources at the country's disposal in relation to its current needs.

In the interest of economic development it need hardly be said that every attempt should be made by the authorities to gain control over the country's foreign exchange earnings which in the context of the Bahamas plays a critical part in defining the scope for governmental action and policy.

Foreign Currency Deposits Held by Residents

Many business operations being conducted in the Bahamas are of a nature that involves frequent and in some cases heavy commitments in foreign currency, the disposition of which is normally subject to official regulation. To facilitate the exchange transactions of such concerns, there are two devices which the monetary authorities employ, namely, the letter of accreditation which specifies the amount of foreign currency to which a business can have access within a given time without going through exchange control formalities and procedures; and bank deposits denominated in foreign currency, which can be used without reference to the authorities to meet external commitments. While there are no limits to these accounts which are mainly, if not exclusively held by earners of foreign exchange, the authorities do, however, insist on a monthly statement of all transactions, in which must be shown the sums involved in each, all amounts credited and withdrawn and the balance outstanding at the end of each

TABLE 2.28

FOREIGN CURRENCY DEPOSITS HELD BY RESIDENTS, 1973 – 78

End of Period	Demand $ m.	Deposits %	Other $ m.	Deposits %	Total $ m.	Deposits %
1973	4.8	13.4	31.1	86.6	35.9	100.0
1974	8.8	47.6	9.7	52.4	18.5	100.0
1975	9.1	58.3	6.5	41.7	15.6	100.0
1976	12.2	54.0	10.4	46.0	22.6	100.0
1977	8.4	46.4	9.7	53.6	19.1	100.0
1978	10.6	47.5	11.7	52.5	22.3	100.0

Source: Central Bank of the Bahamas.

period. An idea of the foreign currency balances outstanding at the end of each year for the period between 1973 and 1978 is given in Table 2.28. At the end of 1978, foreign currency deposits held by residents amounted to $22.3 million which was equivalent to 8.2 per cent of total Bahamian dollar deposits outstanding. The total amount appears to fluctuate a great deal from period to period.

While foreign currency deposits held by residents are intended for use in external transactions, they, nevertheless, represent potential spending power within the local economy, since they can be converted to the domestic currency at any time. As far as U.S. dollar deposits are concerned, there would not even be any need for conversion, since this currency circulates side by side with the local medium and is accepted freely for the payment of any amount. Both these possibilities, however, have to be viewed against the stringent conditions[72] attached to the operation of foreign currency accounts by resident companies, which, if adhered to, would considerably limit their use in domestic transactions.

Bahamian Dollar Deposits Owned by Non-residents

From earlier discussions, it is clear that the bulk of these liabilities are intended for spending in the Bahamas, and this is the major criterion in determining whether they should or should not be treated as part of the money supply. Unlike places like the U.S. and Britain where foreign held deposits denominated in local currency are generally excluded from any narrow definition of the money supply for the reason that such holdings are not necessarily intended for spending in those countries, the Bahamian dollar is not an international currency held for reserve or trade purposes. To the extent that non-resident owned Bahamas dollar deposits are intimately related to local transactions, they should be regarded as eligible for inclusion in any definition of the local money stock.

Having looked at some of the difficulties involved in deriving a stock of money concept, we now turn our attention to a brief examination of the relationship between the two major components of this aggregate, namely, demand deposits and currency. In Tables 2.29 and 2.30 we present the respective contributions of each at the end of selected periods between 1950 and 1978. The currency figures exclude U.S. money in circulation (for which there are no up-to-date or reliable estimates) but 'non-local' B$ balances are included in deposits. Foreign currency deposits held by residents are also excluded. For reasons stated earlier, while it is not possible to draw any conclusions on the basis of the 1950 figures which do not take into consideration sterling currency in circulation around that time, the data for recent years clearly reflects the dominance of deposits as a medium of exchange. In recent years demand deposits have been amounting to over 70 per cent of the money supply narrowly defined. The relatively higher proportions in the late '60s/early '70s were, no doubt, heavily influenced by the 'non-local' Bahamian dollar accounts, which as indicated earlier, have been declining since then. The fact that currency forms about 20 per cent of the money supply in the developed countries gives some idea of the extent of monetisation of the economy.

Factors Affecting the Money Supply

Given the importance of the liabilities of commercial banks in the exchange system and the obvious implications of this for monetary policy, this might be a good point at which to make some general remarks on the factors determining the level of money in the existing structural and institutional environment of the Bahamas. This might serve as a background to the later discussion on the control of the money supply and monetary policy generally.

In a situation where money consists only of currency which is closely linked to the level of foreign exchange reserves, the critical determinant of the supply of money is the balance of payments. In circumstances, however, where there are commercial banks operating on a fractional reserve system, and whose liabilities are being used as a medium of payments, the behaviour of these institutions in response to changes in reserves is vitally

TABLE 2.29

THE MONEY SUPPLY (CURRENCY[a] IN CIRCULATION PLUS BANK DEPOSITS[b]) 1950 TO 1978

$ m.

End of Period	(1) Currency with Public	(2) Private Demand Deposits[c]	M_1 (3) (1) + (2)	(4) Savings Deposits	(5) Time Deposits	M_2 (6) (3) + (4) + (5)
1950	1.9[d]	19.6	21.5	4.4	1.2	27.1
1969	17.2	72.7	89.9	43.6	65.1	198.6
1970	17.7	64.2	81.9	43.5	55.3	180.7
1971	15.1	53.6	68.7	44.9	65.1	178.7
1972	21.2	63.6	84.8	44.9	62.2	191.9
1973	20.0	59.0	79.0	45.3	53.7	178.0
1974	19.2	58.5	77.7	45.8	70.7	194.2
1975	20.0	54.4	74.4	45.9	91.8	212.1
1976	20.3	58.2	78.5	50.6	113.2	242.3
1977	23.1	68.2	91.3	55.1	118.0	264.4
1978	26.4	81.4	107.8	66.7	124.6	299.1

a: Excluding U.S., currency.

b: Includes 'non-local' B$ deposits but excludes foreign currency balances held by residents.

c: Does not include demand deposits held by the Central Bank.

d: Not strictly comparable with other years; the currency figure represents only local notes; the volume of British currency in circulation around this time is not known.

Source: Central Bank of the Bahamas.

TABLE 2.30

% COMPOSITION OF MONEY SUPPLY (CURRENCY PLUS DEMAND DEPOSITS), 1950 – 1978

	M_1			M_2		
	(1)	(2)	(3)	(4)	(5)	(6)
End of Period	Currency with Public %	Private Demand Deposits %	Total	Currency with Public %	(2) + Saving and Time Deposits %	Total %
1950	8.8	91.2	100.0	7.0	93.0	100.0
1969	19.1	80.9	100.0	8.7	91.3	100.0
1970	21.6	78.4	100.0	9.8	90.2	100.0
1971	22.0	78.0	100.0	8.4	91.6	100.0
1972	25.0	75.0	100.0	11.0	89.0	100.0
1973	25.3	74.7	100.0	11.2	88.8	100.0
1974	24.7	75.3	100.0	9.9	90.1	100.0
1975	26.9	73.1	100.0	9.4	90.6	100.0
1976	25.9	74.1	100.0	8.4	91.6	100.0
1977	25.3	74.7	100.0	8.7	91.3	100.0
1978	24.5	74.5	100.0	8.8	91.2	100.0

Note: footnotes to Table 2.29.

Source: Table 2.29

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important in determining the quantity of money in existence at any point in time. In saying this, it is not intended to imply that the balance of payments is an irrelevant variable in this process. In fact, in any open economy domestic financial aggregates are bound to be influenced by movements in the external accounts. The question, it seems, is one of degree which will vary according to the importance of the commerial banks in the monetary system. The larger the role played by these institutions (and particularly if they are part of international concerns) the less rigid would tend to be the link between the balance of payments and the money supply, and vice versa. Once banks are introduced into the discussion a further consideration that has to be taken into account is the public's preference for holding currency and deposits. This is a critical factor that has to be taken into account in any analysis of banks' money-creating ability.

Traditionally, discussions on factors determining the level of money, particularly in the context of a Currency Board type system, have tended to be conducted within the framework of what Betz has called the 'balance-sheet' type approach which "consists of a combination of remarks on the major items in a monetary identity and related but unsystematic implicit theorizing on why these items varied as they did".[73] A typical example of this approach can be seen in Table 2.31 which is compiled from various issues of the *Quarterly Review* of statistics published by the Central Bank of the Bahamas. This type of table (properly organised and with accurate information) can, of course, provide us with some general insights into the immediate causes responsible for changes in the money supply over a period of time. For example, the data as set out in the table can give a fairly good indication of the influence of external and internal factors in the money supply changes, including the role of the private and public sectors in the process. This kind of analysis, however, is deficient, in that it does not focus on the behavioural relationships and responses which were pointed out earlier as being critical to the determination of the quantity of money. In recognition of this shortcoming, attempts have been made in recent years to use what has been called 'the proximate determinant' method (which is a development of the familiar fractional reserve model) to explain changes in the level of money.[74]

The three main factors or 'determinants' in this approach which was first developed by Friedman and Schwartz[75] , in their study of the United States, are 'H' which is called 'high powered money' and which is defined as bank reserves and currency in circulation; 'b' which is the reciprocal of the ratio of bank reserves to bank deposits; and 'p' which is the reciprocal of the ratio of currency in circulation to bank deposits. With some simple manipulation [76] the multiplier can be written as

$$\text{Equation (1)}\quad M=H.\ \frac{b(1+p)}{(b+p)}$$

where 'M' is the stock of money. This 'multiplier', it should be noted, is not unique and can be varied to take account of different definitions of 'M' and 'H'. Whatever the variant used, the value of each 'determinant', including the interaction between 'b' and 'p', can be obtained by taking the logarithms of Equation (1) and differentiating with respect to time, thus splitting changes in 'm' i to changes in 'H', 'b' and 'p'.[77]Over discrete periods, the effect of each determinant can be approximated by holding the other two determinants constant at their initial values, while allowing the particular determinant to take its observed rate of change.[78]

TABLE 2.31

'FACTORS DETERMINING THE LEVEL OF MONEY, 1973–78'
(End of Period)

	Items	1973	1974	1975	1976	1977	1978
1.	**Foreign Assets (Net)**	**(43.2)**	**(92.6)**	**(77.5)**	**(59.9)**	**(67.8)**	**(71.8)**
a.	Central Bank Holdings	40.0	41.6	45.5	40.0	61.0	52.3
b.	Treasury Holdings	3.2	8.0	7.8	1.6	–	–
c.	Bahamas Gold Tranche	a	a	a	5.8	6.1	6.5
d	Commercial Banks	(124.3)	(142.2)	(130.8)	(107.3)	(134.9)	(130.6)
2.	**Domestic Credit**	**312.8**	**326.1**	**340.8**	**366.8**	**394.6**	**432.3**
a.	Claims on Govt. (Net)	26.8	57.7	68.7	89.0	81.6	99.0
b.	Claims on Private Sector	286.0	267.1	264.5	275.4	311.2	331.1
c.	Claims on O.L.F.I. in Bahamas (B$ only)	17.0	1.3	7.6	2.4	1.8	2.2
3.	**Money Supply**	**76.5**	**76.2**	**73.7**	**83.3**	**91.8**	**106.6**
a.	Currency in Active Circ.	20.0	19.2	20.0	20.3	23.1	26.4
b.	Demand Deposits	56.5	57.0	53.7	63.0	68.7	80.2
	i. Commercial Banks[b]	54.9	56.2	52.7	55.5	64.2	77.2
	ii. Central Bank	1.6	0.8	1.0	7.5	4.5	3.0
4.	**Quasi Money**	**140.9**	**135.9**	**154.7**	**188.1**	**195.5**	**216.1**
a.	Deposits in F/C	35.9	18.5	15.6	22.6	18.1	22.3
b.	Savings Deposits (B$)	43.7	45.6	44.7	48.8	54.6	66.5
c.	Fixed Deposits (B$)	51.7	68.8	89.8	110.2	116.8	123.3
d.	Due to O.L.F.I. (B$)	9.6	3.0	4.6	6.5	6.0	4.0
5.	**Other Items**	**50.5**	**38.3**	**40.3**	**30.8**	**39.6**	**38.0**

a: Included in 'Treasury Holdings'.

b: Figures exclude 'non-local' B$ deposits.

O.L.F.I. Other Local Fiancial Institutions.

F/C Foreign Currency.

Source: Central Bank of the Bahamas, *Quarterly Review,* various issues.

In order to ascertain the effects of these factors in the determination of the Bahamas money supply an exercise was undertaken using data for 1973 and 1978.[79] The results are presented in Table 2.32. Here one can see the overwhelming impact of high powered money on both the narrow and the broad stock. Acting as an offsetting influence are changes in the bank reserve/deposit ratio 'b', and this is particularly more pronounced with

TABLE 2.32

CONTRIBUTIONS OF DETERMINANTS TO MONEY SUPPLY CHANGE, 1973 TO 1978[a]

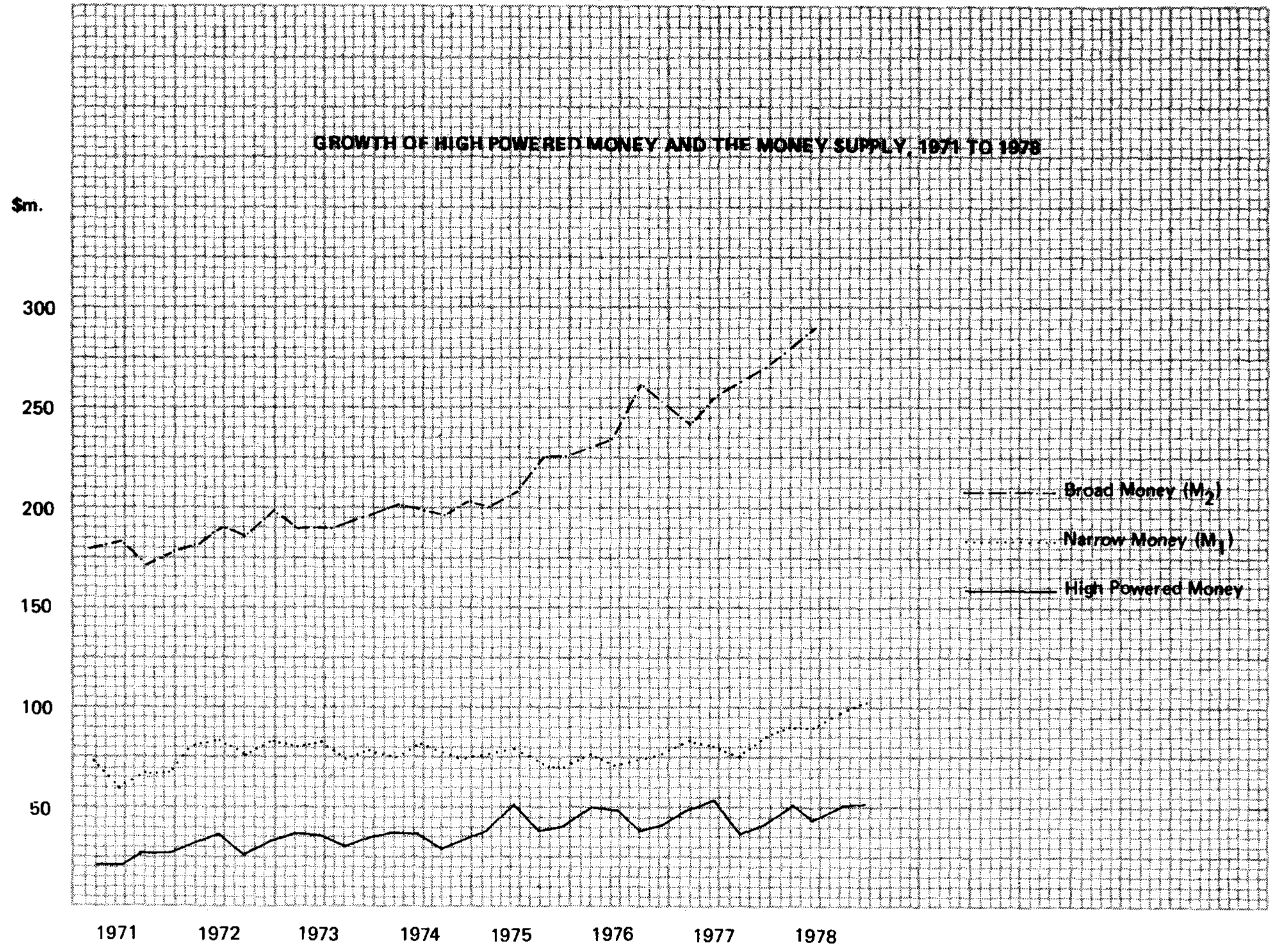
Proximate Determinants	Narrow Money	Broad Money
H	234.5	112.7
b	–131.2	–34.9
p	5.6	25.7
Interaction of b and p	–2.1	–3.7
Sum of Effects	106.8	99.8

a. Computations done on the basis of average end of month figures for the two years concerned.

respect to the narrow version of the money supply. The public currency/deposit ratio 'p' appears to have an expansionary effect on both stocks, but much more so in the determination of the broader concept. The interaction between 'b' and 'p' is of a contractionary nature. A glance at Figure 2.2 shows that over the 1971-78 period, 'p', whether based on the narrow or the broad definition has tended to fluctuate less than either version of 'p' In fact, the demand deposit/currency in circulation ratio was almost constant from the end of 1972.

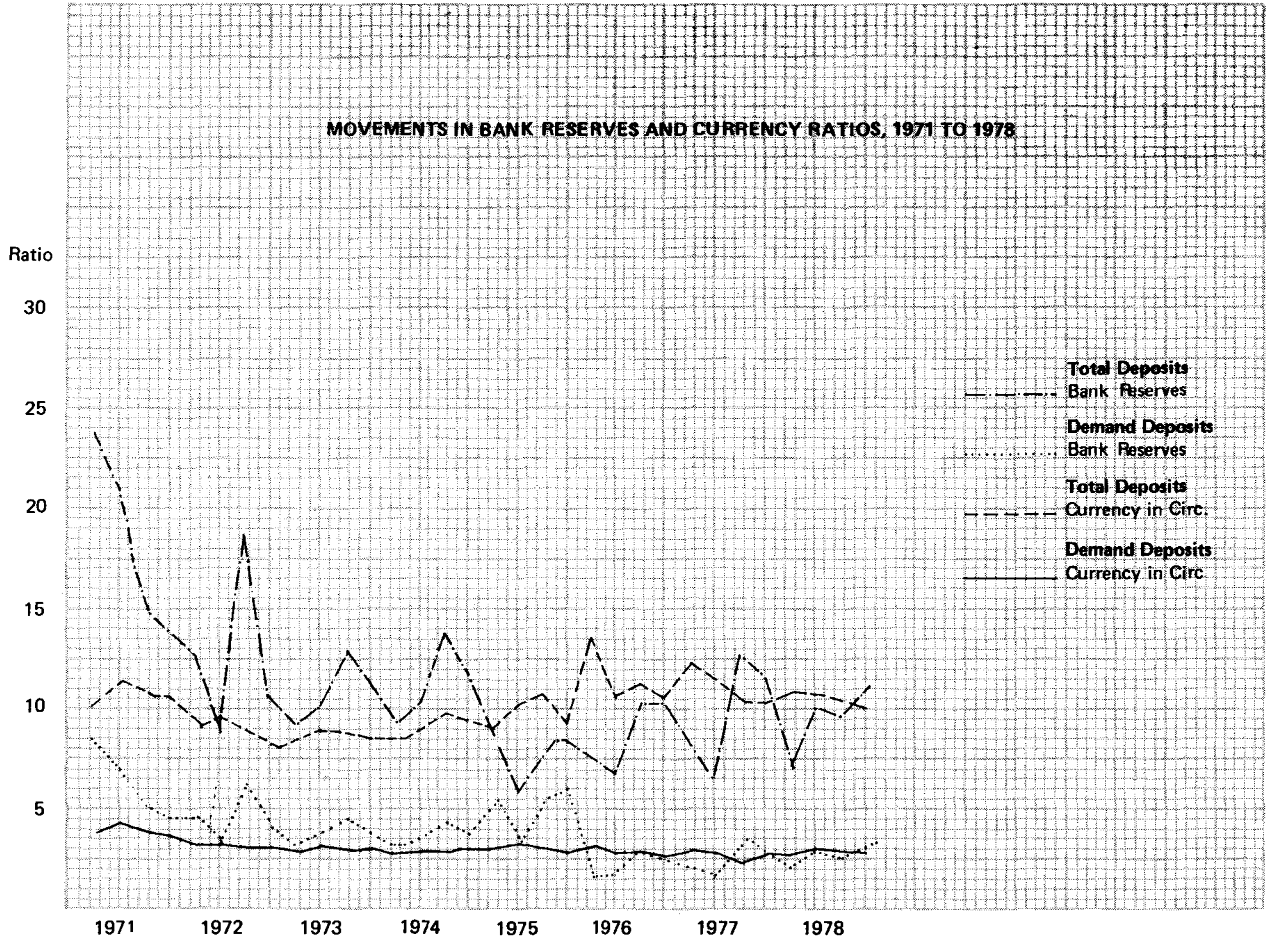
The level and growth of high powered money tend to be affected by a ber of factors. Some of the major ones are the balance of trade and services, capital movements and Central Bank credit to Government. The balance of payments factor for the Bahamas is still going through a refining stage and, therefore, in order to get some idea of the impact of external transactions on the money supply, we have used changes in official reserves (Δ R) as a proxy in a regression exercise involving changes in currency in circulation (ΔC), changes in the narrow or active money supply (ΔM_1) and changes in the broad money supply (ΔM_2) as dependent variables. The results are presented in the following three equations.

FIGURE 2.1



GROWTH OF HIGH POWERED MONEY AND THE MONEY SUPPLY, 1971 TO 1978
$m.
300
250
200
150
100
50
1971
1972
1973
1974
1975
1976
1977
1978
Broad Money (M_2)
Narrow Money (M_1)
High Powered Money

FIGURE 2.2


MOVEMENTS IN BANK RESERVES AND CURRENCY RATIOS, 1971 TO 1978
Ratio
30
25
20
15
10
5
1971
1972
1973
1974
1975
1976
1977
1978
Total Deposits
Bank Reserves
Demand Deposits
Bank Reserves
Total Deposits
Currency in Circ.
Demand Deposits
Currency in Circ

$$(1)\quad \Delta C = \underset{(0.529)}{0.770} - \underset{(0.49)}{0.045}\,\Delta R \qquad R^2 = 0.366 \quad D.W. = 2.578$$

$$(2)\quad \Delta M_1 = \underset{(1.491)}{2.772} + \underset{(0.138)}{0.119}\,\Delta R \qquad R^2 = 0.440 \quad D.W. = 1.989$$

$$(3)\quad \Delta M_2 = \underset{(1.494)}{5.283} + \underset{(0.138)}{0.079}\,\Delta R \qquad R^2 = 0.650 \quad D.W. = 1.870$$

From equation (1), it can be seen that changes in official external reserves 'explain' 37 per cent (value of R^2) of the movements in currency in circulation. In fact, from the negative coefficients associated with changes in R, it would appear that effect on currency movement tends to be in the opposite direction. From equation (2), it seems that the balance of payments explains a higher proportion of the movements in the active money supply than in currency in circulation. With respect to the broad supply the proportion explained is still even higher – 65 per cent.

Before concluding this chapter, there are two important questions closely related to bank lending activities, to which some attention should be given. One is the issue of interest rates, which will be dealt with first. The other is the regulatory framework within which instalment credit and hire purchase finance operations are conducted.

Factors Affecting the Level of Local Interest Rates

Up until very recently, because of the existence of the Sterling Area Arrangements which provided for the easy movement of funds between London and the overseas members and the virtual absence of exchange risks, changes in the Bank of England Rate tended to have a direct and almost immediate impact on local deposit and lending rates. The explanation for this relationship as given by a group of bankers before the Radcliffe Committee in 1957 ran as follows:

> **Question:** *What action is taken as a result of a change in interest rates in London relatively to those prevailing elswhere?* **Answer:** *Whan a change takes place in the level of the Bank Rate in London, the information is immediately conveyed to our overseas territories. The normal procedure in the case of currencies firmly linked to sterling is for the local banks to confer*

TABLE 2.33
INTEREST RATES FOR SELECTED COUNTRIES, 1971–1978
(Percentages)

Date	Bahamas Central Bank Re-discount Rate[a]	Bahamas Comm. Banks[b]	Canada[c]	U.K.[d]	U.S.[e]
15.12.71	–	8.5	6.00	4.50	5.25–5.50
16. 2.72	–	8.5	6.00	4.50	4.50–4.75
16.10.72	–	9.0	6.00	7.0	5.6
15.12.72	–	9.0	6.00	7.5	5.75–5.875
15. 1.73	–	9.0	6.00	8.25–8.50	6
15. 2.73	–	9.0	6.00	9.50	6
16. 4.73	–	9.0	6.50	9.00	6.50
15. 6.73	–	9.0	7.75	8.00–8.50	7.50
16.10.73	–	9.0	9[f]	11.00	10
15.11.73	–	9.0	9[f]	13.00	10
15. 1.74	–	9.0	9.5[g]	13.00	9.75–9.9
15. 2.74	–	9.5	9.5[g]	13.00	9–9.25
15. 3.74	–	9.5	9.5[g]	13.00	8.5–8.75
16. 4.74	7.9	9.5	9.5	12.50	9.75–10
15. 8.74	8.5	9.5	11.50	12.00	12.00
10. 4.75	8.15	9.5	9.00	11.00–12.05	7.75–8.25[h]
16. 6.75	6.51	9.5	9.00	10.00	6.75–7.25[i]
15. 6.76	4.15	9.5	10.25	11.50[j]	7.25
12.12.77	5.89	9.5	8.25	11.50	7.00
13.10.78	3.58	9.5	10.25	10.00	10.00

a: The figures given here refer to rates prevailing at available dates nearest to dates given in the first column of the table.

b: Prime Rate movement over recent years was as follows:
- At 31. 8.69 = 7%
- 1. 9.69–2.11.69 = 8%
- 3.11.69–April 1972 = 8.5%
- May 1972 to Sept. 1972 = 7.5%
- Oct. 1972 to Dec. 1973 = 9.0%

c: Prime Rate.

d: Base Rate minimum rate at which the Bank of England lends to money Market.

e: Prime Rate for major New York banks.

f: at 8. 8.73

g: at 8.12.73

h: at 6–11.3.75

i: at 15.5.75

j: Base rate for clearing banks 10.50% since May 28 (except for one bank 11% May 25 –June 14).

Source: Central Bank of the Bahamas; *Euro-money,* various issues.

among themselves as to the effect the Bank Rate change has on the local structure of money rates. Hitherto, local rates have generally changed more or less automatically with a change in the London Bank Rate. If the Bank Rate in London went up, advance rates and deposit rates would also go up and vice versa . . .

By and large the trend is and must be for local rates to follow rates there, as long as transfers between the United Kingdom and overseas territories of the Sterling Area are not subject to restriction by the local monetary authorities. . . . High interest rates here, imposed as part of a credit squeeze, sooner or later attract surplus funds from overseas territories and lead to a falling off of local banking deposits which the local banks cannot sit by and watch. Local credit interest rates have then to be increased in the endeavour to stop the outward flow. At the same time, local concerns which have previously obtained finance from the United Kingdom parent companies or merchants here find this source of finance curtailed and have to turn to the local banks. Overdraft rates have therefore also to be increased both to meet the extra cost of raising deposits and to check the increasing pressure of demand from local would-be borrowers.[80]

Since the late 1960s, a number of events have taken place which have affected the overall framework within which local interest rates were linked to the London Bank Rate. The first of these was the sterling devaluation of 1967, which brought home to local depositors and financial institutions the exchange dangers of holding funds abroad. A second and more important factor was the redefinition of the sterling area by the United Kingdom government in 1972 to include only the United Kingdom, the Isle of Man, the Channel Islands and the Republic of Ireland. In effect, this was the end of the sterling area and the Bahamas, like other overseas members, reacted by setting up its own exchange control regime in which sterling and the currencies of other 'scheduled territories' were declared to be foreign currencies and made subject to the same controls applicable to other currencies. Under these new regulations foreign accounts can only be held by residents with the permission of the authorities, as is the case with the making of investment abroad. Lending by financial institutions to foreign owned concerns has also been made subject to official approval.

With these changes, the domestic banking system, though dominated by branches of foreign institutions, is therefore no longer under the same kind of pressures prevailing prior to 1972, to follow movements in the United Kingdom Bank Rate regardless, of local conditions. A glance at Table 2.33 shows that the Bahamas Prime Rate[81] (i.e. the rate charged by commercial banks to their most creditworthy borrowers) has, with the exception of a brief period in 1972, been kept in a range of 8.5 to 9.5 per cent since the end of 1971. The U.K. Bank Rate on the other hand increased from 4.50 per cent toward the end of 1971 to 13.0 per cent in 1974, since when it has shown a tendency to decline. With respect to the Central Bank discount rate established in recent years there appears to be no relationship either with the level of or with the direction of movements in the U K. rate. If we examine Table 2.34 which shows the interest rates paid by banks on deposits, it will be observed that since 1969 the savings rate has more or less remained in the 4 to 5 per cent range, while the fixed rate has varied around a level of 5 to 7 per cent. Against this background it is interesting to note that lending rates on all classes of loans have increased significantly in the 1970s.

From the above discussion, we do not mean to imply that the local rates bear no relationship to their external counterparts at all times. Clearly, when the aim is to attract funds over which the authorities have no control, and which are responsive to returns in other markets, the differential between local and foreign rates will have to be sufficiently large to make the whole exercise a worthwhile one. In this sense, one can say that there is an interdependence or, if one likes, a link between the local and external money markets, the connecting strand being the movement of non-resident owned funds. Countries, therefore, which are heavily dependent on foreign sources for short term capital would obviously find it more difficult to pursue independent policies than countries which are self-sufficient in such funds or virtually so.

Because of the apparent indifference which has been shown to the cost and other conditions at which funds have been made available to the public by financial institutions in the past, and the consequent lack of attention that has been paid to the collection of data pertaining to this question, it is not possible to say very much on the trends of borrowing rates for various types of finance over any great length of time. The Prime Rate figures shown in Table 2.33 can generally be taken as the lower limit, while the upper limit on loans has its authority in Act 25 of 1948 which prescribes a figure of 25 per cent per annum simple interest on loans of more than £25 (B$71.42) and 30 per cent on loans of £25 or less 'irrespective of the date fixed for repayment of the said loan'. While the Act, it should be noted, stipulates a penalty of £100 (B$285.70) or six months imprisonment (or both) for contravention of its provisions, it appears that it has never been rigidly enforced, mainly no doubt because there has never been the need to, given the exceedingly high ceiling. In the light of the sophisticated lending techniques which have emerged in recent years, there is urgent need to review both this legislation and the Money Lending Act of 1913 which sought to protect borrowers against unscrupulous money lenders, and which is now sadly out of date. The irrelevance of the 1948 Act in particular can be seen by looking at Table 2.34 which shows the rates on two broad categories of loans in recent years. These figures, it should be noted, however, represent average rates which generally do not include 'add on' charges which are normally calculated in the instalment figures. The actual rates vary from borrower to borrower depending on a host of different factors such as risk, length of time for repayment of the loan, security, etc.

In a number of countries, movements in the Prime Rate (PR) tend to be viewed as one of the major indices of credit conditions. It is also widely recognised that in situations where there are not many borrowers who qualify as 'most creditworthy' customers, the PR tends to become a 'window-dressing' device serving public relations purposes. The pattern that it assumes over time will not reflect the degree of flexibility in the credit rate structure and, hence, the real cost of borrowing. In the Bahamas there is no indication of what volume of funds (or the number of loans) outstanding has been made available at Prime Rate. Nor is there any information that would permit us to relate interest rates charged to such factors as the size of loans, type of security, repayment period or the method of repayment.

In view of the importance of interest rates in the process of economic development, both as a reward for saving and as the cost of capital, it is imperative that the authorities make a greater effort to monitor their movements and to exert some influence on their levels and structure within the framework of local conditions. With the Central Bank now operational, and given the new administrative framework, this exercise should be less difficult than it was in the past when the local money market was highly integrated with those of foreign countries.

This brings us to a final point on which a great deal of attention has come to focus in the last few years, and this is the need for active interest rate policies in the mobilisation of savings and allocating resources as between different forms of investment, instead of merely viewing interest rates as a means of regulating the cost of availability of credit. In the Bahamas, as in many other developing countries, it can be observed that while the cost of funds of borrowers has tended to increase over time at a relatively rapid rate, the income to savers, particularly at the lower end of the accounts spectrum, has hardly moved at all. This comes out to some extent in Table 2.34 which shows that while the rates paid on deposits barely changed between 1969 and 1978, interest charged on mortgages increased from 9 per cent to about 12 per cent over the same period. The increase in consumer loans rates was even greater, almost doubling in the period. In a situation where prices are rising at a faster rate than the nominal interest rate paid to depositors, the result is a negative real rate of return to savers, and there is no doubt that this has been the case in the Bahamas in recent years, as Table 2.34 clearly shows. Since 1969, inflation in the Bahamas has averaged around 7 per cent per annum.

While there is some controversy over the extent of influence which interest rates exert on the level of savings, there is no doubt that a decreasing

TABLE 2.34

SELECTED BAHAMIAN INTEREST RATES[a] AND MOVEMENTS IN RETAIL PRICE INDEX[b], 1969 TO 1978

	Deposits %		Lending %		
Year	Savings	Average Fixed	Consumer Loans	Mortgages	Retail Price Increases %
1969	3.90	6.10	8.9	9.0	10.6
1970	4.20	6.60	9.0	9.4	4.6
1971	4.30	7.20	9.5	9.6	5.3
1972	4.40	7.10	9.7	10.1	5.8
1973	4.85	7.09	12.95	11.42	9.4
1974	3.94	7.54	12.23	11.50	13.6
1975	5.02	7.28–8.30	17.38–18.50	12.53–12.86	6.5
1976	4.73	6.52–7.88	16.77–18.00	12.07–12.08	3.2
1977	4.74	5.69–6.88	15.76–19.48	11.82–12.13	4.6
1978	5.20	5.06–6.79	15.37–17.58	11.57–11.88	6.6

a: Based on quarterly averages.

b: Year-end to year-end changes in New Providence Retail Price Index (November/December 1971 = 100).

Sources: Central Bank of the Bahamas, *Quarterly Review*, various issues; publications of the Department of Statistics.

real rate of return will sooner or later affect the propensity of savers to hold bank accounts, and consequently the funds available for investment. In the Bahamas, as in several other developing countries, we have the anomalous situation of the banks being able to adjust their lending rates to take account of inflation and also having the power to control deposit rates which are often set on the basis of inter-bank agreement.[82] The short term affect of such a policy, in which savings rates are pegged at very low levels is the subsidisation of borrowers by savers and/or higher bank profits as the spread increases. The longer term consequence is likely to be a damper on savings efforts with repercussions on capital formation and economic growth. In view of this, the responsibility of the authorities is clearly to take a more active part in determining what are the most appropriate rates in the context of prevailing conditions, rather than leave it all to the whims of private enterprise with their often narrow motives and horizons which may be completely unaffected by social or other broad economic considerations. Within such a policy an attempt can also be made to use the interest rate weapon as a means of allocating resources between the various sectors according to some pre-determined set of priorities established within a development framework.

The Hire Purchase Act of 1974

Although it has been decided to discuss this particular law in this chapter, it should be pointed out that banks are not the only organisations involved in hire purchase finance. Some of the institutions that we shall discuss in Chapter 4 also provide credit under various types of instalment arrangements.

To begin with it should be noted that the Hire Purchase Act of 1974 does not cover bank lending (or for that matter lending by other financial institutions) which is still governed by the Money Lending Act of 1973 and the 1948 Rate of Interest Act mentioned in the previous section. As Thomas has observed with respect to the laws in other Commonwealth Caribbean countries, the legal fiction of separating credit from sales has led the authorities into regulating "hire purchase and credit sales, whilst ignoring the lending of money by banks on an instalment basis of consumer purchases".[83]

A reading of the 1974 hire purchase legislation shows that the main purpose is to provide a legal framework within which transactions between buyers and sellers involving some form of credit can be conducted. The aim is to protect sellers as much as buyers in dealing with each other, and the Act therefore goes into great detail in outlining the rights and obligations of both parties. However, as will be seen, it is neither perfect in relation to the scope and objectives to which it addresses itself, nor adequate in dealing with the overall credit situation.

The credit arrangements with which the statute is concerned take three forms:

(a) **The Conditional Sale Agreement:** *Under this type of agreement a buyer is given possession of goods in return for a commitment to pay the purchase price or part of it by instalments. Ownership remains in the seller until such time as conditions relating to the payment of instalments and other matters specified in the agreement are fulfilled.*

(b) **Credit Sale Agreement:** *This is an agreement for the sale of goods under which the purchase price is payable by five or more instalments. Unlike the passing of the property arrangement defined in the conditional sale agreement, in credit sale transactions ownership normally passes to the purchaser immediately upon the completion of the agreement. In other words, this is an agreement for the outright sale of goods in which the buyer is permitted to pay the purchase price by five or more instalments.*

(c) **Hire Purchase Agreement:** *This is an agreement for the bailment (hire) of goods under which the bailee (the hirer) may buy the goods or under which the property in the goods can pass to the bailee (the hirer)*

With the exception of Part III which deals with transactions relating to motor vehicles, the legislation is applicable only to agreements which do not exceed $10,000.00. It should be noted, too, that no distinction is made between limited liability companies and individuals, either as buyers, sellers or hirers.

Agreements by owners or sellers are only enforceable if these agreements meet certain specific requirements laid down in the Act. These relate not only to the proper execution of the agreements themselves, but also to the insertion of certain types of information in them. These include, inter alia:

(i) the hire purchase price or total purchase price (specifically stating the rate of interest payable) as the case may be;

(ii) the cash price of the goods to which it relates;

(iii) the amount of each instalment by which the hire purchase price or total purchase price is to be paid;

(iv) the date, or mode of determining the date upon which each instalment is payable.

In an effort to protect the hirer or buyer, the law contains extensive provisions dealing with circumstances of default, death of hirer or buyer, termination of agreement, etc. In cases where, under an existing agreement, one half of the hire purchase price has been paid by a hirer or buyer, the owner or seller cannot enforce any right to recover possession of the property, except through action in the courts of the Bahamas.

Given the abuses to which consumers have often been subjected in the past, there is no doubt that the Hire Purchase Act of 1974 was a long overdue piece of legislation.[84] There are, however, a number of shortcomings in the Act, which also appear to characterise the statutes of other countries in the region,[85] to which sections of the Bahamas Law seem to bear a close resemblance. The first of these relate to the question of liability for the merchantable quality of the goods bought or hired, the provisions governing which appear to be quite vague and inadequate, particularly when viewed against the various hire purchase arrangements obtaining in practice. Not only is the party responsible not clearly identified in transactions involving more than two parties, but the whole question of the nature, content and publicity of warranty is very ineptly dealt with.[86] A second criticism that might be levelled at the Act concerns the proportion of the hire purchase or total purchase price that must be paid to avoid arbitrary seizure. This can reasonably be reduced from the present 50 per cent to about a third, which is the level obtaining in many countries. A third shortcoming which could be mentioned is the "failure to distinguish clearly between consumer and commercial transactions, and between corporate and non-corporate borrowers".[87] Such an approach would no doubt have permitted the incorporation of an element of economic rationalisation in the legislation, based on social and developmental considerations, rather than the purely legalistic concerns which motivate its provisions. A fourth criticism which one could make of the Act relates to the quality of expression or the language used. Since this legislation affects such a wide spectrum of people, a greater effort might have been made to produce a clearer and simpler statute capable of easy interpretation and understanding. Some of the provisions of the 1974 Hire Purchase Act have come almost word for word from the 1904 Sale of Goods Act, often without any attempt to improve on the expression or the articulation of the concepts involved and the effect intended.

Finally, we shall note that since bank lending for consumer purposes is still largely unregulated, one consequence of the hire purchase legislation may be to encourage arrangements which do not come under the purview of the 1974 law. In this situation, there would appear to be a clear need for an urgent revision and updating of the existing regulations governing bank lending with a view to preventing the systematic exploitation of people incurring debts in order to make an acquisition. At the same time, the recommendation that some sort of Consumer Credit Authority should be set up in other Commonwealth Caribbean countries[88] is also one highly relevant to the Bahamas situation. While there are several useful and necessary functions which such a body can carry out, the major one would, of course, be to administer the laws in the sense of acting as a reference body and thus preventing too frequent a recourse to the courts, which can often involve a great deal of expense and frustration, both for consumers and sellers. Acting in this capacity, this body will be well placed to keep a check on the abuses to which consumers are subjected and to suggest remedial action from time to time. The responsibility for administering the regulations relating to the advertisement of goods, for which the Act makes provision, can also be delegated to the Authority.

In concluding this section, there are a few final observations worth making. In most countries where income has been growing one finds a parallel growth taking place in consumer instalment credit. In many instances the ratio of repayments to disposable income has increased significantly in recent years. Borrowers cover a wide spectrum of income and age groups. As an activity, therefore, that has deep social and economic implications consumer instalment credit needs to be closely monitored and controlled. In this connection, an important prerequisite is the systematic collection of data on a regular basis, which could both provide indications of trends and identify areas for correctional measures arising from the increasing use of instalment credit facilities.

Concluding Comments

Commercial banks in the Bahamas operate under a peculiar set of constraints and conditions. While these factors may have some effect on their behaviour, the basic function of these institutions remains the mobilisation of the community's savings and making these resources available to borrowers. The fact that they occupy a significant position as intermediaries in the financial system implies an important role for their activities from a developmental perspective.

While, as we have indicated several times before, the liabilities of commercial banks tend to be essentially of a short term nature, nevertheless, they are still able, on the basis of experience, to divert a proportion of their resources to medium and longer term lending without defaulting on their obligations. Banks with easy access to funds in times of difficulty or with a capital base, can be even more flexible in their lending activities than institutions relying for their resources solely on deposits or having extremely limited access to facilities outside their own structure. There is no question that the commercial banks in the Bahamas (despite the absence, in most cases, of a local capital base[89]) have long term funds at their disposal as is seen in their eagerness to subscribe to long dated government stock. A large amount of these funds, however, are being channelled mainly into areas which offer the highest returns from the banks' point of view, or to riskless investments, with the result, as indicated earlier, that critical sectors of the economy are suffering from an insufficiency of credit availability. It seems almost superfluous to say that while financial institutions are entitled to a profit, they also have a social responsibility to the community in which they operate, and in this context, the goal of maximising income to the neglect of all other considerations, certainly has to be modified. With respect to the total volume of savings generated, there is scope for more innovative ideas and policies which could reduce the high levels of current spending and divert resources to more productive uses. A higher level of domestic savings has the effect of reducing dependence on foreign funds. The question of the relationship between yield (or the rate of interest) and savings needs to be rationally examined. Another device which has proved particularly successful in some countries is that of 'tied savings'. This concept refers to an arrangement in which savings are made on the understanding that the savers will receive credit in an amount greater than their savings for some specified purpose. Inability to obtain funds from lending institutions often acts as disincentive to the development of the saving habit.

Finally, there is need to make a statement on the information collected from the banking sector. In recent years, there is no doubt that there has been considerable progress in this particular area, both in respect of the range and quality of the data. There still, however, remains some room for improvement. One particular area to which attention needs to be directed is the maturity structure of loans. The present form designed for this purpose is highly inadequate. Another is the real cost of borrowing. This involves much more than mere collection of interest rates. The volume of loans covered by particular rates as well as the type of collateral required for various forms of credit are also relevant in this context. A periodic survey could be used to gain additional information which might be difficult to obtain through the monthly reporting currently employed.

APPENDIX 2.1

OWNERSHIP STRUCTURE OF THE COMMERCIAL BANKING SYSTEM
(Position at End of 1978)

U.K BRANCHES:	1. Barclay's Bank International
U.K SUBSIDIARIES	1. Charterhouse Japhet Bank and Trust International. 2. Bank of London and Montreal Limited. This bank is a wholly-owned subsidiary of Lloyd's Bank International Limited.
U.S BRANCHES.	1. Chase Manhattan Bank 2. Citibank
U.S SUBSIDIARIES AND AFFILIATES:	1. Bank of New Providence Limited. This is an affiliate of Chemical New York Corporation (CNYC) but is supervised by Chemical International Finance Ltd., a wholly-owned subsidiary of Chemical Bank.
CANADIAN BRANCHES:	1. Canadian Imperial Bank of Commerce. 2. Royal Bank of Canada. 3. Bank of Nova Scotia.
CANADIAN SUBSIDIARY:	1. Bank of Montreal (Bahamas and Caribbean) Limited. This is a wholly-owned subsidiary of the Bank of Montreal, Canada. It has its beginnings in the 1970 reorganisation of BOLAM, which up to that time was jointly owned by Barclays, the Bank of Montreal and the Bank of London and South America Ltd., (BOLSA).
CONSORTIUM SUBSIDIARY:	1. SFE Bank and Trust (Bahamas) Ltd. This institution is part of the Societe Financière Europeène (SFE) group owned by the following nine banks: Algemene Bank Nederland NV(Netherlands), Banca Nazionale del Lavoro (Italy), Bank of America (U.S.A.), Banque Nationale de Paris (France), Barclays Bank International Ltd. (U.K.), Dresdner Bank AG (Germany), The Sumitomo Bank, Ltd. (Japan), Union Bank of Switzerland (Switzerland).

FOOTNOTES

1. Act 5 Wm. IV c 39.
2. The *Gahan Report* (An official enquiry into the affairs of the Public Bank carried out in 1885 by C.F. Gahan who was sent by the Colonial Office to discharge temporarily the functions of cashier.)
3. *Ibid.*
4. Though the Bank had virtually ceased operations the year before, it did not formally close until 31 March, 1886.
5. When the Bank suspended payments in 1885, the sum standing to the credit of depositors totalled £86,194 and cash balances £166.
6. Gahan, *op. cit*
7. *Ibid.*
8. Act 52 Vic. Cap. I. Under this law, the bank was authorised to carry on the business of banking for 21 years.
9. The person, however, who was probably most instrumental in bringing about the establishment of this institution was the then Governor of the country, Sir Ambrose Shea (1887–94) whose portrait was to appear on the first issue of the bank's notes, as a token of appreciation for the part he played.
10. With the closure of the bank, the note issue of £6,500 which it had in circulation and which was fully guaranteed by the Government was withdrawn.
11. Royal's entry into the Bahamas was a direct result of an invitation to open a branch in Nassau by the then Governor W. Grey Wilson whose suspicions of the operations of the Bank of Nassau (the custodian of the Government's funds) were aroused shortly after his arrival in the Bahamas in 1904. The Charter under which the bank was established allowed it to operate with a great deal of secrecy, so much so, that a request by the Governor in 1906 for a detailed financial statement from the Bank was flatly refused by the Directors, whose influence in the House of Assembly was also sufficiently strong to deter any contemplated amendment to the Charter when it came up for renewal in 1908. It should be noted, however, that while the misuse of the Bank by the Directors and shareholders contributed in no small measure to its downfall, the critical factor was an embezzlement carried out, over a period of time, by two successive cashiers, a father and son.

    As a point of interest we might note that Royal's offer to set up an office in the Bahamas was at first made on the condition that the "Government will make us their depository and will favour us with all their banking business, terms being equal with those of any other bank. We could not undertake to pay interest on the Government's deposits".

    It is interesting to note that this condition was being laid down in a situation where there was another bank in the country owned by citizens of the country, whatever may have been its financial position.

    Replying to Royal's Manager on behalf of the Governor, the Colonial Secretary indicated that although he (the Governor) could not give an undertaking "that the Government will make your bank their depository, His Excellency can assure your Directors that the Bank will receive 'most favoured nation treatment' and every support that he is able to afford it".

    The reason for this guarded reply stemmed from the concern that any switch of the Government's deposits to Royal from the Bank of Nassau would have resulted in a run on the latter institution. And it was, undoubtedly, this concern that explains the Government's continued patronage of the Bank of Nassau until its collapse in 1917.
12. This institution did not start dealing in non-sterling currencies until 1960.
13. This bank (which now operates exclusively in the foreign currency market as the Bank of Virginia (Bahamas) Limited) was not related in any way to the earlier Bank of Nassau.
14. Closed in 1963.

15. Though this institution holds an authorised dealer/agent licence its operations are almost exclusively foreign oriented.

16. Includes the People's Penny Savings Bank.

17. It should be noted that under the special charter on which the Bank of Nassau was established in 1888, this institution was authorised to issue its own notes. The need for a more general law, however, became necessary with the entry of the Royal Bank of Canada and the possibility that this institution might also have wished to issue its own notes. With the closure of the Bank of Nassau in 1917, and given the unwillingness of the Royal Bank to issue its own notes plus the introduction of the Currency Board System in 1919, the note issuing provisions became redundant and were omitted from subsequent versions of the law.

18. It should be noted that then and even now the banks engaged in international operations publish statements relating to their world-wide business rather than accounts pertaining just to their local activities.

19. See Frank Davis, "Criteria Utilized in Evaluating Licensing of Financial Institutions – Value of Different Types of Licences for Financial Institutions". Paper presented at the Conference on Current Issues in Bank Supervision and Regulation: The Caribbean Basin Perspective held at the Federal Reserve Bank of Atlanta, 1–3 August, 1978.

20. To secure a 'public' licence, a bank must have a minimum paid-up capital of $1,000,000 and a trust company a minimum of $500,000. In the case of a 'restricted' licence, a minimum paid-up capital of $100,000 is required. In both cases there are certain additional conditions to be met. See Davis, *op. cit.*

21. In cases, however, where the Inspector requires information on a depositor or a depositor's account, this can only be obtained under the authority of an order of a judge of the Supreme Court "made on the ground that there are no other means of obtaining the information required by him".

22. According to a report appearing in the Financial Times of 9 October, 1973, no less than 10 'public' licensed banks involving some $27 million of depositors' money folded up in the four years preceding this date. Among the reasons cited for the failure were the long term nature of the investments acquired, and the defaulting of a number of loans against which there was no security. In all cases, depositors were not expected to recover any but a small proportion of their total funds – and that after a considerable lapse of time. Investments are normally scattered around the world, and therefore subject to the laws of various countries. Of the over $10 m. owed by the British American Bank, for example, only about $3 m. were invested in the Bahamas.

23. The terms 'resident' and 'non-resident' are essentially balance of payments concepts.

24. For a discusssion of these arrangements, see BMA 1971 *Annual Report*, p. 26.

25. *Ibid.*

26. The existing limit in the Bahamas is B$½ m. for a long or short open position.

27. The first part of this section draws heavily on S.W. Robinson's *Multinational Banking*, Leiden, A.W. Sijthoff, 1972 .

28. D.B. Zenoff, *International Business Management*, New York, The Macmillan Company, 1971 , p. 203.

29. Robinson, *op. cit.*, p. 30.

30. The same situation is believed to obtain with British and Canadian banks.

31. Zenoff, *op. cit.*, p. 203.

32. One disadvantage resides in the fact that the U.S. bank can be subiect to suit under local law for the debts contracted by the branch as well as for torts or other acts committed by the locally established unit. Even more serious, the bank itself can be sued in the host country by service of process against the branch bank there. (Robinson, *op. cit.*, p. 31.)

33. See Robinson, *op. cit.*, p. 31.

34. Or with another non-resident bank.

35. It might be pointed out here that it is possible to have control with 50 per cent of the voting stock in circumstances where the rest of the shares is widely distributed.

36. Zenoff, *op. cit.*, p. 203.

37. One element of this expertise is what has come to be known as 'International Cash Management' or 'International Money Management' which is concerned with the sourcing, positioning, moving and protecting of money. The broad objectives of international cash management which, incidentally, is not limited to financial companies, are similar to those of domestic cash management. These have been summed up by Zenoff as follows: "To minimise the cost of funds to the corporation; To ensure that funds are available when and where they are needed to carry out the main business of the firms; To derive a satisfactory return on investment; To protect corporate funds commensurate with top-management preferences". (D.B. Zenoff, "International Cash Management: Why it is Important and How to Make it Work (*Worldwide Projects and Installations,* July/August, 1973).

38. R.J. Clark in D.R. Croome and H.G. Johnson (eds.), *Money in Britain, 1959–1969,* Oxford University Press, 1970, p.138.

39. *Ibid.,* p.139.

40. These may or may not be of the same nationality.

41. See Alberto A. Weissmuller, "London Consortium Banks", *Journal of the Institute of Bankers,* August, 1974.

42. For example, MAIBL, Western America and Orion.

43. Robert Ball, "International Banking Gets the Team Spirit", *Fortune,* June, 1972.

44. The locally owned People's Penny Savings Bank which at the moment is relatively insignificant and does not offer many of the services provided by the other banks is excluded. The figure, however, includes the Bank of London and Montreal which, though possessing an authorised dealer licence, is forbidden from doing local business by reason of its non-resident status which it acquired in 1972. Effectively, therefore, there were 10 commercial banks at the end of 1978.

45. Barclays Bank, for example, holds 49.04 per cent of the shares in Barclays Bank of Trinidad and Tobago Limited, an associated company which it formerly owned. The Royal Bank of Canada has also recently set up two subsidiary companies, one in Jamaica and the other in Trinidad. In June of 1972, Jamaican nationals were offered a 25 per cent equity interest in Royal Bank Jamaica Limited which now operates the Royal network in that country and in which it is hoped Jamaicans will eventually hold 51 per cent of the outstanding shares. Virtually the same arrangements apply to Royal's other subsidiary, the Royal Bank of Trinidad and Tobago Limited. The Bank of Nova Scotia Trinidad and Tobago Limited was activated in May, 1972, and at 31 October, 1978, 58.8 per cent of the capital stock was owned by the Bank of Nova Scotia. The Bank of Nova Scotia, Jamaica Limited is a controlled subsidiary.

46. They were only 30 per cent lent at the time of the devaluation. See, CBB, *Quarterly Review,* June, 1974, p. 26.

47. One method of this repatriation initially took the form of special term deposits with the BMA in return for an exchange rate guarantee by the latter in late 1968 – an arrangement that appeared to have been tied up with the Sterling Area Agreement. These balances rose from B$12.3 m. at the end of December, 1968 to B$19.9 m. in April, 1969 and thereafter gradually declined. By the beginning of 1970, there were completely withdrawn.

48. Under Section 19–(2) of the Central Bank Act the permissible statutory reserve range is 5 to 20 per cent of deposit liabilities. Different percentages can be fixed for different classes of commercial banks.

49. BMA 1971 *Annual Report,* p. 26.

50. Perhaps the best example of such a transaction was the $30 m. consortium loan raised in 1973.

51. The total funds borrowed through B$ stock issues between 1974 and the end of 1978 amounted to almost $120 million.

52. See Roland I. Robinson, *The Management of Bank Funds,* New York, McGraw Hill Book Co., 1962, p. 134.

53. *Ibid.,* p. 135.

54. Up to a few years ago the rules were even more liberal, permitting a national bank to extend mortgage loans up to an amount equal to its unimpaired capital and surplus or to 78 per cent of its time and savings deposits, whichever was greater.

55. See 1963 *Bahamas Handbook,* p. 220.

56. *Ibid.*

57. Excerpt from L.O. Pindling's booklet *Building a Nation Through Peace, Understanding and Love*, presented to the 1970 PLP Convention.

58. One of the most notable contributors is the Chase Manhattan Bank which in 1973 made available a $10 m. facility. Other less significant contributors have been Imperial Life Assurance Company and Abbey International.

59. Speech relating to 'Project Impact' delivered on 30 July, 1975.

60. The gross total of authorised dealers' B$ deposits with each other amounted to $9.8 m. at the end of 1978. The banks also borrow from each other. Both sets of figures vary widely over time.

61. While this is largely true for domestic retail banking, it is less so for international wholesale financing involving large sums and relatively longer term lending. In the latter case, equity resources can add significantly to the flexibility required for such operations.

62. 'Approved Investment' is an exchange control term applied to foreign exchange brought into the Bahamas, and which has an official guarantee that repatriation would be permitted when the desire arises.

63. This is the conception held by at least one institution to whom the author spoke.

64. See S.W. Payton, *The Monetary Organisation of the Bahamas.* Report prepared for the Government of the Bahamas, 1968.

65. While the income velocity of money can be calculated for any definition of money, the narrow supply is the most commonly used base.

66. There is no formal definition of what constitutes a savings account in the Bahamas.

67. This was the mid-1979 position.

68. The population/office ratio (roughly) for selected Commonwealth Caribbean countries are as follows: Barbados, 5,416 (1978); Guyana, 37,272 (1978); Jamaica, 13,200 (1978) and Trinidad and Tobago, 13,830 (1977).

69. See Phillip Cagan, *Determinants and Effects of Changes in the Stock of Money 1875–1960*, Princeton, Princeton University Press, 1965, p.3.

70. See BMA *Annual Report,* 1971, 1972 and 1973.

71. An exception has been the period up to the late 1920s when some American gold and a small amount of silver coin circulated in the country by proclamation (see chapter on the Currency System).

72. These are set out below in standard form. A foreign currency account to be maintained with a bank in the Bahamas will be permitted subject to the following conditions being strictly observed:

    (a) Credits or deposits to the account shall be restricted to any of the following items: (i) Foreign currency includes receipts in the normal course of business. This category includes receipts from tour companies, hotel guests, conventions, etc.; (ii) Borrowings for which specific Central Bank permission has been obtained; and (iii) Non-resident subscription to company shares.

    (b) Debts or payments from the account shall be confined to the following items: (i) Imports; (ii) Advertising and promotion; (iii) Travel Agents commissions; (iv) Refund or advance deposits; (v) Repayment of loans and advances; (vi) Repatriation of profits and dividens; and with respect to (i) and (vi) specific prior permission of the Central Bank must be obtained.

    (c) Balances in excess of current requirements shall be converted into Bahamian dollars.

    (d) No payments shall be made to companies or persons deemed resident in the Bahamas for Exchange Control purposes and

    (e) Copies of the bank statements for the account together with copies of cancelled cheques shall be submitted to the Central Bank to arrive not later than 15th of the month following that to which they relate. A typed list specifying briefly the nature and/or purpose of each payment from the account shall accompany the above copies.

    All non-resident companies are allowed to maintain foreign currency accounts without reference to the Central Bank.

73. George Betz, "A Note on the Money Supply in Singapore, 1957–1966", *Malayan Economic Review,* October, 1967.

74. It should be pointed out that many of the criticisms levelled at the simple deposit multiplier also apply to this method. Two major weaknesses which should be noted are the assumptions of constancy in the behavioural relationships on which the predictive quality of the model rests, and the independence between the factors which determine the determinants. An implicit assumption is that 'M' depends on 'H' and not the other way round. See A.D. Bain, *The Control of the Money Supply,* Penguin Modern Economics, 1970, pp.66–68.

75. Milton Friedman and Anna Schwartz', *A Monetary History of the United States, 1867 to 1960,* Princeton, N.J., Princeton University Press ,1963.

76. Given the following definitions: M = money supply; D = bank deposits; C = currency in circulation; R = bank reserves; H = C + R

$$M = C + D$$

$$H = C + R$$

$$\text{Then } \frac{M}{H} = \frac{C+D}{C+R} = \frac{\frac{D}{R}\left(1+\frac{D}{C}\right)}{\frac{D}{R}+\frac{D}{C}}$$

$$M = H.\ \frac{\frac{D}{R}\left(1+\frac{D}{C}\right)}{\frac{D}{R}+\frac{D}{C}}.$$

$$M = H.\ b\frac{(1+p)}{(b+p)} \quad \text{where}$$

$b = \frac{D}{R}$ = the reciprocal of bank deposit to bank reserve ratio.

$p = \frac{D}{C}$ = the reciprocal of the public cash ratio.

77. $\log M = \log H + \log b + \log (1+p) - \log (b+p)$

$$\frac{1}{M}\frac{dM}{dt} = \frac{1}{H}\frac{dH}{dt} + \frac{p}{b(b+p)}\frac{db}{dt} + \frac{(b-1)}{(1+P)(b+p)}\frac{dp}{dt}$$

See Friedman and Schwartz, *op. cit.,* Appendix B.

78. See Betz, *op.cit.*

79. This period was chosen because of the greater reliability of the data in these years.

80. Radcliffe Committee, *Principal Memoranda of Evidence,* Vol. 2, pp. 64–65.

81. This rate, which represents the cost at which the banks are prepared to make credit available to their best customers is fixed after discussions among the clearing banks have taken place and the Central Bank has given its approval. Other banks then tend to fix their own rates in some relationship to the Prime figure operated by the clearing banks.

82. It should be pointed out however, that when changes in the basic rates are contemplated the concurrence of the authorities is sought. The banks generally do not appear to compete on rates. In fact, until recently a maximum rate was observed.

83. See C.Y. Thomas, "Consumer Instalment Credit in the Caribbean" (A Report and Survey) presented at the Monetary Studies Conference held in the Bahamas in May of 1972, pp. 149–150.

84. Before this law the main legislation governing credit-sales transactions in the Bahamas was the Sale of Goods Act of 1904.

85. See C.Y. Thomas, "Consumer Instalment Credit", *op. cit.*

86. For an outline of the United States' approach to this aspect, see *Time Magazine* of 9 February, 1976, p. 37.

87. This is a criticism that has also been levelled at other Commonwealth Caribbean legislations. See C.Y. Thomas, "Consumer Instalment Credit", *op. cit.*

88. *Ibid.*

89. Here reference is being made mainly to the clearing banks which dominate the local B$ market.

CHAPTER 3

THE INSURANCE INDUSTRY AND THE BAHAMIAN ECONOMY

The Structure of the Local Insurance Market

At the end of 1977, there were 64 companies licensed to transact business of an insurance nature in or from within the Bahamas. Of this number, 48 were engaged in domestic operations in varying degrees. The presence of the others whose activities were exclusively 'off-shore' stemmed largely from the fiscal advantages to be derived from having an office domiciled in the Bahamas. As stated earlier, a discussion on this latter group will be reserved for a later section of the study.

On the basis of the type of license issued by the Bahamas Government, it is possible to categorise insurance operators into three groups. The relevant data are presented in Table 3.1 which gives a breakdown of insurers according to the type of business they write. At the end of 1977, of the 48 companies participating in the local market 28 (58.3 per cent) were engaged exclusively in non-life business, while 20 (41.7 per cent) were active in life underwriting. Of these 20, 18 were composite companies, i.e. companies writing both life and non-life business.

TABLE 3.1

NUMBER OF INSURANCE COMPANIES[a] BY TYPE OF LICENSE AND DIRECTION OF BUSINESS AT THE END OF 1977

Type of Insurer	(1) External Operators	(1b) % of Total	(2) Local Operators	(2b) % of Total	(3) (1) + (2)	(3b) % of Total
'Life'	2	12.5	2	4.2	4	6.2
'Life & Other than Life'	2	12.5	18	37.5	20	31.2
'Other than Life'	12	75.0	28	58.3	40	62.6
All Companies[a]	**16**	**100.0**	**48**	**100.0**	**64**	**100.0**

a: It should be pointed out that the official list available contained the names of a few companies which were no longer in operation, or were in the process of being struck off the register.

Source: Office of the Registrar of Insurance Companies.

Since the late '60s/early '70s, the number of insurance companies engaged in the domestic market has been declining, even if slowly. For example, at the end of 1973, there were 60 insurers (life and non-life) as compared to 48 at the end of 1977. The present company/population ratio is about one insurer to every 5,000 persons. If we take into account only the companies engaged in life business, the ratio works out to around 12,000 persons to a company. Whichever ratio we choose to consider, this situation reflects a comparatively high insurance density for the Bahamas.[1] Available figures pertaining to the early '70s indicate that for countries such as Canada, the United Kingdom, West Germany and the United States the insurance ratio was more than 40,000 persons to a company. For Japan, it was more than one million persons to an insurer.[2]

It is worthy to point out that the companies/population (or the population/companies) ratio may mean very little in economic terms. A more significant indicator of insurance penetration is the number of policies per unit of population. It is estimated that at the end of 1975 there were 119,971 policies in force with a total value of $531.4 million and an average value of $4,429 (See Table 3.2). Given a population of 208,000 at that time, the 'penetration ratio' works out to about one policy to two persons. Since it was estimated that there were 48,300 households in the Bahamas in 1975, this would imply that there were more than two policies to every household.

TABLE 3.2

NUMBER OF POLICIES BY TYPE AND AVERAGE VALUE OF EACH TYPE, 1975 (END).

Type of Policy	No.	Total Sum Assured $'000	Average Value of Each Type
Term	1,502	60,804	40,482
Whole Life	11,486	225,474	19,630
Endowment	5,072	22,307	4,398
Industrial Life	101,734	84,302	829
Group Life	177	138,512	782,554
All Types	**119,971**	**531,399**	**4,429**

Note: The figures in the table exclude the operations of two of the smaller companies for which we had no data. These companies issue mainly industrial policies.

Source: Special requests by Registrar of Insurance.

A second feature of the industry worth noting is the high degree of concentration when looked at in terms of premiums received (Table 3.3). In 1977, only 15 companies had total premiums exceeding one million dollars. Together, they accounted for 85 per cent of total premiums collected in that year, while 26 companies were responsible for the remaining 15 per cent. Concentration is particularly noticeable in the life business which is covered by 20 companies, (18 also doing 'general' under-writing) as compared to 28 engaged exclusively in non-life business. Details on average premium per company for 1977 are presented in Table 3.4, where it can be observed that the average for the 'Life & Other than Life' group, which normally receives about 99 per cent of the total life premiums was almost twice that of companies engaged exclusively in the non-life business. Another point worth noting with respect to the data appearing in Table 3.3, is the fact that in recent years there has been an increase in the number of insurers in the higher premium brackets. An examination of this table will show that while there has been a drop in the number of operators in each of the categories under $1 million in the period between 1971 and 1977, there have been concomitant increases in the two higher groups. For example, while the number of companies in the less than $100,000 premium bracket fell from 24 in 1971 to eight in 1977, the number in the $2 to $4 million category increased from three to nine over the same period. This trend can be attributed to a number of factors which we shall discuss a little later.

However, an obvious one which needs to be mentioned here stems from the folding up or withdrawal of some of the smaller and weaker insurers from the market in the light of relatively poor performances and uncertain objectives in some cases.

A final characteristic that comes out of an examination of the insurance business in the Bahamas is one that also characterises the industry in most other Commonwealth Caribbean countries,[3] and that is the dominance of the foreign owned enterprises operating in the local market. Of the 48 companies licensed to write domestic business at the end of 1977, 43 or 90 per cent were foreign owned. Of the latter group, 18 had American ownership, four were of Canadian origin, 18 were based in the United Kingdom while the remaining three were of various other nationalities.

Besides the prominent feature that foreign operators collected 88.5 per cent of the premiums in 1977, there are two other points of interest worth noting. The first is that the Canadian insurers which represented only 8.3 per cent of the total number of local operators in 1977 accounted for 22.3 per cent of the total premium income collected in that year. The major explanation for this undoubtedly lies in the fact that all the Canadian companies are engaged in life underwriting, which, as we pointed out earlier, tends to be more highly concentrated than the non-life business. A second reason stems from the fact that Canadian companies are among the oldest insurance establishments operating in the Bahamas. In other words, they

TABLE 3.3

INSURANCE COMPANIES CLASSIFIED ACCORDING TO THE VALUE OF PREMIUMS COLLECTED, 1971 AND 1977

Categories		1971 No. of Companies	1971 Premiums collected $'000	1971 %	1977 No. of Companies	1977 Premiums collected $'000	1977 %
Less than	$100,000	24	820	3.1	8	213	0.5
1000,000	– 200,000	10	1,420	5.5	4	662	1.6
200,001	– 500,000	13	4,543	17.6	11	3,514	8.4
500,001	– 1,000,000	7	5,501	21.3	3	2,068	4.9
1,000,001	– 2,000,000	4	5,920	22.9	6	7,565	18.0
2,000,001	– 4,000,000	3	7,644	29.6	9	27,908	66.6
Total[a]		61	25,848	100.0	41	41,930	100.0

a: Excludes inactive companies.

Source: Returns to Registrar of Insurance, Bahamas

TABLE 3.4

AVERAGE PREMIUM COLLECTED PER COMPANY[a], 1977

Type of Insurer	Type of Premium: Life $'000	Type of Premium: Non-Life $'000	All Premiums $'000
'Life'	95.7	–	95.7
'Life & Other than Life'	970.5	449.0	1,419.5
'Other than Life'	–	770.8	770.8
All Companies			**1,022.7**

a: Active companies only.

Source: Returns to Registrar of Insurance, Bahamas.

have had more time in which to build up their business than most other companies.[4]

The second point to be observed in connection with Table 3.5 is that most insurers prefer to operate through branches or agencies rather than locally incorporated offices. Of the 43 foreign owned firms writing domestic business in the Bahamas in 1977 only 13 or 30 per cent were doing so through locally formed companies. Almost all of the latter were subsidiaries of foreign based insurance corporations. In at least two known cases, however, the Bahamian based companies were being operated as the head office for the shareholders' international insurance business.

As is the case with commercial banks, there are no legal specifications with respect to the form of organisation a foreign entity should take in seeking to conduct local insurance transactions. As we shall see later, the Insurance Act of 1971 requires a minimum paid-up capital, but this does not have to be held in the Bahamas. With respect to firms using a branch or agency operation, the tendency of the local supervisory authorities has been to use the international assets/liability position of insurers against which to measure domestic financial requirements and eligibility criteria. Given this situation, the form of operation chosen by foreign insurance concerns tends to reflect their individual needs in terms of their overall tax position, their depth of commitment in exploiting the domestic market and their general operational flexibility.

TABLE 3.5

NATIONALITY OF INSURERS AND TYPE OF ESTABLISHMENT (END OF 1977)

Country of Ownership	Type of Operation (1) Locally Inc. Offices	(2) Branch/ Agency	(3) (1) + (2)	%	Share of Total Premium $'000	%
U.S.	5	13	18	37.5	14,357	34.2
U.K.	–	18	18	37.5	10,133	24.2
Canada	1	3	4	8.3	9,333	22.3
Bahamas	5	–	5	10.4	4,825[a]	11.5
Other	2	1	3	6.3	3,282	7.8
Total	**13**	**35**	**48**	**100.0**	**41,930**	**100.0**

Source: Office of the Registrar of Insurance, Bahamas

Insurance and the Level of Income

While we do not have any data which would enable us to assess the growth and changes in the insurance industry over any great length of time, it is clear on the basis of the figures we have for recent years that the insurance sector has come to occupy an important place in the financial system of the Bahamas. Premiums collected in the Bahamas, both on a per capita basis and as a per cent of GNP, compares well with some of the most developed countries in the world. In 1975, the average per capita premium collected amounted to $163.68 as compared to $215.00 for France, $198.00 for Britain and $182.00 for Japan. Among the developing countries shown in Table 3.6, the Bahamas had the highest per capita premium. In terms of premiums as a per cent of GNP, the Bahamas ranks even higher. In 1975, this ratio was over 5.6 per cent , putting the Bahamas second only to the United States among the countries shown in Table 3.6.

The relatively high per capita premium cited for the Bahamas reflects, to a large extent, the high level of living the country has attained in recent years. That there is a close relationship between per capita income and per capita premium is a proposition that is easily acceptable and in fact one that can be backed up statistically.[5] Another factor which seems to bear some relationship with savings and hence with insurance coverage is the distribution of income. The more unequal the latter, it is sometimes argued, the higher the level of savings tends to be — a proposition that is supported to some extent by the data in Table 3.6. There, it can be observed that Trinidad with a higher per capita income than Jamaica is seen to have a lower per capita premium than the latter, which is reputed to have a more and more highly skewed distribution of income. The relatively high per capita premium for the Bahamas is also associated with a very uneven distribution of income.[6]

The Growth of Premium Income

While the high level of per capita income is, undoubtedly, the most important overall factor explaining the growth of insurance premiums, there are a number of other considerations which have to be taken into account in the broad context of the economic conditions of the country and the individual and social perceptions which emerge in a rapidly changing environment.

More effective and intense marketing provides one explanation for the growth of the insurance business. Another, of course, is the expansion of the economy in terms of people and physical assets, accompanied by a greater understanding of the nature and purpose of the insurance transaction.

As indicated earlier, insurance has come to form an important part of Bahamian social and economic life. In 1975, premiums collected amounted to 4.5 per cent of the estimated personal income of $315 million for that year. The statistics for the two subsequent years presented in Table 3.7

TABLE 3.6

THE SIGNIFICANCE OF INSURANCE IN THE ECONOMIES OF SELECTED COUNTRIES 1975

Countries	Premium (U.S. $ m.) Non-Life	Life	Total	Per Capita Premium $U S.	Per Capita GNP[a]	Premiums as a % of GNP
U S.A.[b]	66,152	39,501	105,653	494.8	7,200	6.8
Japan[c]	7,125	13,046	20,171	182.4	4,600	3.9
W. Germany	11,451	7,290	18,741	303.1	6,720	4.5
Gt. Britain[b]	5,324	5,776	11,100	198.4	3,860	5.1
France	8,522	2,817	11,338	214.8	6,070	3.5
Canada	4,532	3,234	7,766	340.2	7,270	4.7
Switzerland	1,565	1,246	2,811	439.2	8,760	5.0
India	284	651	935	1.6	140	1.1
Argentina	480	18	498	19.6	1,580	1.2
Brazil	961	183	1,144	10.7	1,160	0.9
Mexico	431	231	662	11.0	1,010	1.0
Venezuela	288	148	436	36.4	2,300	1.6
Jamaica	57	64	121	59.2	1,200	4.9
Bahamas[d]	20	16	36	176.5	3,089	5.3
Trinidad & Tobago	28	29	57	52.7	1,950	2.7

a: The GNP data used in this table are at market prices; the population figures are mid-year estimates.
b: Premium figures are estimated or provisional.
c: Premium year relates to period 31 March, 1975 to 31 March, 1976.
d: The GNP figures used are IMF and World Bank estimates.

Sources: *Sigma,* No. 5/May 1977; *Monetary Statistics,* 1976, Department of Statistics, Jamaica; *Annual Statistical Digest,* 1976/77, CSO, Trinidad; the GNP data like most of the population statistics are taken from the *World Bank Atlas,* various issues; Office of the Registrar of Insurance, Bahamas.

TABLE 3.7

DISTRIBUTION OF PREMIUM BY TYPE OF RISK, 1971 – 1977

Year	Total Premiums $'000	Life Premium $'000	Life Premium % of Total	Non-Life Premium $'000	Non-Life Premium % of Total
1971	25,848	9,928	38.4	15,920	61.6
1972	29,526	12,857	43.5	16,669	56.5
1973	30,700	13,099	42.7	17,601	57.3
1974	31,882	13,901	43.6	17,981	56.4
1975	33,382	14,241	42.7	19,141	57.3
1976	36,472	15,765	43.2	20,707	56.8
1977	41,930	17,661	42.1	24.269	57.9

Note. In each year there would be two or three companies (particularly the smaller ones) for which returns may not be available. In such cases we have had to make estimates on the basis of available information.

Source: Returns to Registrar of Insurance.

would seem to confirm the continued growth of the industry, both with respect to the life and non-life business. Between the period 1971 and 1977, total premiums grew from $25.8 million to $41.9 million or by 62 per cent at an average rate of 8.4 per cent. In real terms, the rate of increase is estimated to have been in the region of 7.8 per cent. Over the same period, life premiums increased from $9.9 million to $17.7 million at an average rate of 10.2 per cent. Non-life premiums, on the other hand, moved from $15.9 million in 1971 to $24.3 million in 1977, at a rate of 7.4 per cent. In 1971, life premiums accounted for 38.4 per cent of total premium collected, while the non-life category contributed 61.6 per cent. In 1972, the contribution of the former class increased to 43.5 per cent, while the latter's dropped to 56.5 per cent. Since then, the respective proportions seem to have remained fairly constant, with slight fluctuations from year to year.

A glance at Table 3.8 shows that while total premiums as a per cent of GNP fluctuated within a range of 5.2 per cent and 7.1 per cent between 1971 and 1977, there was an almost steady upward increase in both per capita life premiums and per capita non-life premiums. The former (in current dollars) grew from $56.24 in 1971 to $80.85 in 1977. The figure relating to the latter, on the other hand, moved from $90.18 to $111.10 over the same period. The overall per capita premiums increased from $146.44 in 1971 to $191.96 in 1977 an increase of 31 per cent as compared to a nominal growth in per capita income of 48 per cent. The period covered in Tables 3.7 and 3.8, it should be noted, was generally one in which little real growth in the Bahamas was taking place. In such a situation, all activities tend to be affected in some way. As far as the insurance industry is concerned, it is worth pointing out that though the growth of premiums may be affected by the reduced contraction of new business, existing policies continue to generate premium income because of the nature of the commitment implicit in an insurance contract which lays down fixed payments over a period of time, irrespective of any changes in the financial circumstances of the insured. A protracted period of a low level of economic activities, of course, would tend to have an effect on the lapse rate.

TABLE 3.8

A COMPARISON BETWEEN PER CAPITA PREMIUM AND PER CAPITA GNP, 1971 – 1977

Year	Per Capita Life Premiums $	Per Capita Non-Life Premiums $	Per Capita Total Premiums $	Per Capita GNP $'000	Total Premiums as a % of GNP
1971	56.24	90.18	146.44	2,321	6.3
1972	70.26	91.09	161.34	2,265	7.1
1973	69.04	92.77	161.81	2,708	6.0
1974	70.67	91.41	162.08	3,079	5.3
1975	69.82	93.85	163.68	3,089	5.3
1976	74.69	98.11	172.79	3,310	5.2
1977	80.85	111.10	191.96	3,433	5.6

Note: The per capita figures were calculated on the basis of mid-year population estimates. The GNP figures used were at market prices.

Sources: Tables 1.4 and 3.7. The Population figures were taken from various publications of the Department of Statistics.

Life Insurance as a Medium of Saving

The purchase of a non-life contract is inspired solely by a desire for protection against loss. There is no saving motive involved in such a transaction. The demand for life insurance on the other hand can be influenced by one or a combination of the two factors, that is, (1) as a method of protection, and/or (2) as a means of accumulating savings. To accommodate these requirements insurance companies provide a wide range of policies which offer various combinations of the two elements. Basically, however, life insurance falls into two classes: (1) term, and (2) whole life (sometimes called 'straight life' or 'ordinary life'). The first offers pure protection while the second combines protection with a savings plan.

Term Insurance

Term insurance is the name applied to an arrangement by which an insurer in return for a premium undertakes to pay a certain sum to a person or persons designated by the life insured in the event of the latter's death within the 'term' specified in the contract. If the insured is alive at the end of stated period nothing is payable. Each 'term' has its own premium rates, but the level remains the same for the duration of the contract period.

Besides the variation in terms (periods)[7] which is associated with this type of policy there are a number of other features which can be had. For example, a policy can be bought with the 'renewable' clause which permits the insured to continue the policy at the end of each term (at, of course, new rates) and without having to undergo further medical examination. There is, also, what is called a 'convertible' term which gives the insured the option of converting his policy into another kind of policy at any time during the term of the contract. 'Decreasing' or 'reducing' term plans are a modification of conventional term insurance. In this case, while the premium remains constant over the entire premium-paying period, the amount of protection decreases from year to year or from month to month as the policy may stipulate.

The major advantage of a term policy lies in the fact that a great deal of protection can be bought for a relatively small premium, which is particularly important in the early years of life when income is not likely to have attained a significant level. And although the coverage to premium ratio tends to vary inversely with age, the advantage does not really disappear since earning power is likely to be enhanced as the years progress.

Whole Life

Unlike the term policy in which premiums tend to increase with age, the whole life contract keeps a level premium throughout the life of the policy which normally coincides with the life of the insured whose dependents or relatives are assured of an agreed sum in the event of his or her death. Another and more fundamental difference between whole life and term is that the former accumulates what is known as 'cash value' which can be withdrawn by the policy holder at any time, or, alternatively, left to grow to the point where it reaches the face value of the policy. The endowment contract is a variation of whole life insurance with emphasis being placed on the savings feature of the plan. Given the relatively shorter maturation period and the higher premiums associated with this arrangement, cash values tend to build up much faster than is the case with ordinary life.

From the above, it can be seen that the element of protection is present in every type of policy, the choice of which can say a great deal about the buyer's motives. For example, one can characterise the holder of a term policy as one purely interested in protection, while a whole life buyer can be described as one seeking protection and a savings plan at the same time. Seen in a broader perspective, however, the distinction in motives is not as sharp as is suggested here. The decision to purchase a term contract may also reflect a saving motive, though in a more indirect and sophisticated way. For while the whole life policy holder is committed to what is virtually a forced' programme of saving over a period of years, which may, in real terms, yield him very little in the long run, the buyer by taking out a term policy not only pays less for his coverage, at least in the early years of the policy, but is in a position with his savings in premiums, to choose and reshuffle his investments in such a way that the yield in the long term may be greater than the return he would have got from an ordinary life contract. In many instances, the fact that an individual subscribes to an ordinary life policy may not reflect the motive implicit in the choice at all, but basic ignorance of the transaction which may be pushed by the agent or salesman because he stands to make a greater commission than he would have by selling a term policy. Another factor which tends to influence the purchase of life insurance and particularly whole life, is taxation, from which premium payments (or at least a portion of it) is exempt in many countries. In the Bahamas, where there are no income taxes, this consideration is clearly of no importance and the growth of 'ordinary-life' type policies (to the extent that this has taken place) has to be explained by such things as the fact that insurance is combined with savings, the systematic way in which the savings take place, the narrow range of investment opportunities, etc.

According to figures relating to the mid-1970s (See Table 3.2), term policies accounted for only about 1 per cent of the total number of policies held Whole life and endowment amounted to 14 per cent while group formed the smallest share, 0.1 per cent. The largest category was industrial life which accounted for 85 per cent. As can be seen in the table, the average value of an industrial policy is comparatively small, about $829 in the mid '70s. The latter feature is one of the main characteristics of this type of policy which generally caters for the low income earner desirous of putting aside a small part of his wage or salary (on a weekly or monthly basis) either as saving or protection or both. There is an element of convenience connected with industrial policies in the sense that the premiums are generally collected by agents at the home of the insureds and this, in itself, may be a source of encouragement for people to decide in favour of this form of insurance arrangement. The popularity of industrial contracts in the Bahamas predates the boom of the 1960s and appears to have developed its roots at a time when the country was basically an agricultural and fishing community and the average family income was generally quite small. In the relatively more affluent environment of today, industrial policies remain attractive to the point where some companies actually specialise in their marketing with good financial rewards.

Income and Expenditure of Insurance Companies

Before proceeding to an analysis of the financial statements of insurance companies, a note of caution needs to be sounded to avoid any misunderstanding or misinterpretation of the data appearing in the tables. Because of the peculiar nature of the insurance business, there is a fundamental difference in representation between the financial statements of insurance concerns and those of operators in other lines of business — a difference which has to be clearly understood in deriving conclusions from an analysis of accounting statistics.

> *In principle, financial statements of other enterprises purport to present the actual picture of the financial conditions of the concern in question at a given date and according to accepted principles of accountancy. Basically, they are historical in nature, deeply rooted in past records and values and intended to give information about the present solvency of the company. Insurance accounts are different. All operations of an insurance company, particularly those of a life assurance company, are long term operations and all decisive items of the financial statements of such companies are dependent on the course of events in a remote future. Consequently, such financial statements are focused into the future and reflect the picture of future expectations in the light of present conditions. Their intention is not only to give information about the present solvency of the company but also about its probably long term future solvency.* [8]

A further difference is seen in the amount of accuracy attained in deriving the major liabilities of insurance concerns and those of other types of enterprises. For while the latter can ascertain its position with a great deal of precision, the major liabilities of insurance companies are nothing more than estimations derived by acturial and other methods.[9]

Some of the differences we have just outlined apply not just to the balance sheet but are also of importance in interpreting the income/expenditure statement, particularly the net operating or underwriting results which can often convey a very wrong impression of performance during the year to which they relate. This arises from the fact that since a great deal of the initial charges are incurred during the first year of a policy, what may look like a bad year, when judged in terms of the net underwriting results, may reflect nothing more than the contraction of an unusually large amount of business. Another item that has an effect on the net results is any payment into reserve funds, which is, in fact, more in the nature of a future rather than a current expense.

The data presented in Table 3.10, as most other financial particulars in this section of the study, are derived from the annual financial statements which registered insurers are requried to furnish to the Registrar of Insurance under Section 18, subsection (1)[10] of the Insurance Act of 1969. The major purpose of this requirement was to determine the solvency of the companies and their ability to meet local obligations, and it was primarily in this light that the reporting forms were drawn up. While providing a fair amount of detail on the local operations of insurance enterprises there are a number of deficiencies (for purposes of economic analysis and policy making) which will be pointed out in the course of the discussion. A further difficulty arises from the fact that certain companies have tended to exercise little care in providing the required data and this has been encouraged to some extent by the lack of continuous official scrutiny.

One of the first things to be observed about Table 3.9 is that for companies engaged in both life and non-life business it has not been possible (if it is possible at all) to obtain a division in all expenditure items which would have enabled the separation of the financial statement pertaining to life operations from that arising out of the non-life business. Availability of the accounting data in two distinct categories would, undoubtedly, have faciliatated a clearer understanding of the behaviour of the two types of operations which tend to be significantly influenced by the differences in the nature of the major liabilities involved. However, from the available figures it is possible to make a number of observations and broad generalisations which can provide some useful insights into the operations and behaviour of these financial firms.

Insurance companies have two main sources of income: premiums and earnings from investments (rents, interest, dividends etc.). It can be observed in Tables 3.9 and 3.10, however, that while the non-life group does not appear to derive a great part of its income from the latter source, earnings from investments are of more significance to the life insurers.[11] More on this point at a later stage. The premium income figures in the table, it should be noted, are aggregative in the sense that they include both first year premiums (i.e premiums from new business) and renewal premiums.[12] (No distinction is made in the reporting form between the two.) The term 'gross' before 'premium income' implies that no account is taken of reinsurance, the role of which will be discussed later in the section. Two other terms which need some explaining are those falling under item 5. Both are 'brought forward' items in the sense that they relate to surplus or residual funds set

TABLE 3.9

INCOME AND EXPENDITURE OF 'LIFE' AND 'LIFE AND OTHER THAN LIFE' COMPANIES, 1971 – 1977

$'000

Income/Exp.	**1971**	**1972**	**1973**	**1974**	**1975**	**1976**	**1977**
Income							
1. Gross Premium Income	14,878	18,578	18,540	19,580	20,590	22,694	25,743
2. Local Investment Income	1,675	2,078	2,625	2,919	3,206	3,350	3,680
3. Other Income	236	268	82	–	703	84	341
4. **Total Income**	**16,789**	**20,924**	**21,247**	**22,499**	**24,559**	**26,128**	**29,764**
5. Add: a. Previous Yr. Premium Reserve b/f	145	169	225	220	195	202	210
b. Outstanding Reserve for Losses from Previous Yr.b/f	261	291	298	370	278	357	400
6. (4) + (5)	**17,195**	**21,384**	**21,770**	**23,089**	**25,032**	**26,687**	**30,374**
7. Commission Paid	2,844	3,372	3,167	3,328	3,864	4,308	5,575
8 Refunds: a. Life	184	225	236	298	282	259	380
b. Other than Life	51	7	287	68	73	406	–
9. Reinsurance: a. Life	158	134	326	368	315	358	380
b.Other than Life	148	120	52	40	35	30	50
10. Claims Paid[a]: a. Life	2,897	3,460	3,456	3,879	4,150	4,947	5,850
b. Other than Life	1,925	2,370	2,618	2,642	2,722	2,422	3,325
11. Local Management Expenses	2,585	3,204	3,403	3,642	4,203	5,188	4,855
12. Management Exp., Charged to Bahamas Operations	988	1,065	1,396	1,471	1,416	1,490	1,853
13. Increase in Life Fund or Reserves	2,878	4,998	3,140	3,569	4,702	5,932	5,749
14. Unearned Premium Reserve	110	267	306	200	224	269	275
15. Other Charges	558	791	784	1,333	381	251	690
16. **Total Exp./Charges**	**15,326**	**20,013**	**19,171**	**20,838**	**22,367**	**25,860**	**27,982**
17. (6) – (16)	**1,869**	**1,371**	**2,599**	**2,251**	**2,665**	**827**	**2,392**

a. Does not include claims outstanding.

Source: Returns to Registrar of Insurance, Bahamas.

TABLE 3.10

INCOME AND EXPENDITURE OF 'OTHER THAN LIFE' COMPANIES, 1971 – 1977

$'000

Income/Exp.	1971	1972	1973	1974	1975	1976	1977
Income							
1. Gross Premium Income	10,970	10,948	12,160	12,302	12,792	13,778	16,187
2. Local Investment Income	144	157	222	193	163	61	58
3. Other Income	86	50	13	39	–	–	–
4. **Total Income**	**11,200**	**11,155**	**12,385**	**12,534**	**12,955**	**13,839**	**16,245**
5. Add: a. Previous Yr. Premium Reserve b/f	3,016	3,572	3,533	4,638	4,514	4,608	4,689
b. Outstanding Reserve for Losses from Previous Yr b/f	2,584	2,722	2,829	2,883	3,460	3,462	3,981
6. **(4) + (5)**	**16,263**	**17,449**	**18,738**	**20,055**	**20,929**	**21,909**	**24,915**
Exp./ Charges							
7. Commission Paid	2,282	2,527	2,663	2,845	2,815	2,800	3,576
8. Refunds	53	89	117	286	42	17	25
9. Reinsurance	508	472	990	783	1,284	1,956	1,530
10. Claims Paid	5,405	3,901	4,582	4,602	5,814	6,215	6,146
11. Local Management Expenses	132	252	421	756	965	1,057	1,047
12. Management Exp., Charged to Bahamas Operations	669	714	503	504	559	417	864
13. Increase in Reserves	664	671	647	188	100	(200)	1,278
14. Unearned Premium Reserve	3,421	3,990	4,458	4,785	4,928	4,488	5,084
15. Other Charges	51	34	277	95	20	116	124
16. **Total Exp./Charges**	**13,176**	**12,650**	**14,658**	**14,844**	**16,527**	**16,866**	**19,674**
17. **(6) – (16)**	**3,087**	**4,799**	**4,080**	**5,211**	**4,402**	**5,043**	**5,241**

Source: Returns to Registrar of Insurance, Bahamas.

aside in previous years to cover unearned premiums and losses and which have been brought forward into the current accounting year. As the name implies, unearned premiums are premiums which have not been earned during the year.

> *The unearned premium reserve represents the portion of the gross premiums on contracts in force corresponding to their unexpired period. It is required in connection with insurance other than life and non-cancellable health insurance. There are two reasons why such a reserve should be carried: (1) because the insurer is obligated to cover the risk for the remainder of the period, and (2) because in most such contracts, the insurer and the insured have the right of cancellation, and on cancellation the unearned premium, or a large percentage of it must be refunded.*[13]

This explanation combined with the difficulty of making accurate calculations, account for the relatively sizeable figures appearing under this item in the table of non-life companies. The loss reserve, of course, is necessitated by the time lag between the incurring of a claim and the actual payment. In fire insurance, for instance, "the amount of loss for which the insurer is liable must be ascertained by investigation and negotiation. This process takes time, so that more claims will be open at any given date than in a corresponding volume of life insurance".[14]

The other items which may need some explanation are 'reinsurance' and increase in life fund' which is the corresponding item for 'increase in reserves' that is characteristic of non-life financial statements. Reinsurance is a normal and widespread practice in the insurance business to which most direct underwriters resort as a means of securing the necessary spread for the risks covered in their portfolio. The term is generally used in reference to the transaction in which one insurer surrenders (for a price) that portion of his risk considered to be beyond his retention capacity to another insurer. Or to be more precise, it is "a system whereby the insurers who deal with the insuring public (and who are known as the direct insurers) cede all (or part) of an insurance to other insurers known as reinsurers. In other words, the ceding company pays to the reinsurers the whole (or part) of the premium it has received and the reinsurers thereupon agree to reimburse to the ceding company the claims (or an agreed proportion of them) which the ceding company may find itself liable to pay under the original insurance".[15]

The increase in life fund or reserves is normally the result of actuarial computation taking into account the changes in the company's obligations over the previous operating year. As the old risks expire and new ones are assumed there is a constant need to adjust the reserve fund to correspond with the changing liabilities structure of the concern if the insurer is to be in a position to meet commitments as they arise.

Bearing in mind earlier comments on the interpretation of financial statements of insurance concerns, attention may now be turned briefly to an examination of the aggregate income/expenditure accounts of insurers operating in the Bahamas.

Firstly, dealing with the companies engaged exclusively in the non-life business, a look at Table 3.11 shows that for each of the seven years between 1971 and 1977 this group experienced a loss in their underwriting activity. Too much should not be made of this, however, since this seems to be more in the nature of an accounting rather than a real loss. It is clear from the substantial figures associated with item 5 in Table 3.10 that the underwriting results are being heavily influenced by over-provision in reserves. In these circumstances, the proper figures to use in order to assess the performance of the sector are the overall operating results appearing in column 6 of Table 3.11. Here it can be seen that the average return over the seven years under consideration was in the region of $4.5 million (with investment) and about $4.4 million (net of investment).

TABLE 3.11

OPERATING RESULTS OF NON-LIFE COMPANIES, 1971 TO 1977

Year	(1) Gross Premiums $'000	(2) Underwriting Profits[a] $'000	(3) (2)[b] as a % of (1)	(4) Investment Income $'000	(5) (4) as a % of (1)	(6) Overall Operating Results $'000	(7) (6) as a % of. (1)
1971	10,970	–2,206	20.1	144	1.3	3,087	28.1
1972	10,948	–1,702	15.5	157	1.4	4,799	43.8
1973	12,160	–2,498	20.5	212	1.7	4,080	33.5
1974	12,302	–2,542	20.7	193	1.6	5,211	42.3
1975	12,792	–3,735	29.2	163	1.3	4,402	34.4
1976	13,778	–3,088	22.4	61	0.4	5,043	36.6
1977	16,187	–3,487	21.5	58	0.3	5,241	32.4

a: Equal to premium income less costs and claims.

b: In absolute terms.

minus sign (–) indicates a loss.

Source: Returns to Registrar of Insurance, Bahamas.

As a proportion of gross premiums, the overall 'operating results' figure ranged between 28 and 44 per cent between 1971 and 1977 – a relationship that seems to be unusually large, though not impossible, given the absence of a corporation tax.[16]

This situation would seem to imply that rates are probably too high in relation to the costs of claims which, as a proportion of total premium income in the seven years under consideration, have fluctuated between 35.6 per cent and 49.2 per cent (see Table 3.12). There are a number of factors which affect rates in relation to claims and, therefore, a more in-depth study is needed if any conclusion of this kind is to be drawn. As far as the other items of expenditure are concerned, the trend in their respective proportions to gross premium varies in each case. In some instances, no clear trend can be discerned. Commission, for instance, has been absorbing between 20 and 23 per cent in the period under consideration. In certain cases, however, there is a clear upward movement in the ratios. The figure pertaining to reinsurance, for example, increased from 4.6 per cent in 1971 to 9.5 per cent in 1977. In at least two intervening years, the proportion was even higher than the latter figure. The local management expenses ratio has also shown a tendency to increase, moving from 1.1 per cent in 1971 to 6.5 per cent in 1977.

Another feature of Table 3.11 worth noting is that for the non-life underwriters investment income is of little significance, never exceeding 2 per cent of premium income in any of the years under consideration. One explanation for this situation, undoubtedly, lies in the fact that the liabilities of this group tend to be more short term than those of their life counter-parts who are thus able to undertake more investments of a long term nature – hence the reason for the substantial investment income normally associated with the latter group.

A point in this connection worth making is that the existence of a significant return from investment can exert a downward influence on premium rates around which competition largely tends to centre in the insurance business. Indirectly, therefore, the use an insurance company makes of its resources has an important bearing on the cost of insurance cover to the community and to the country.

The Income/Expenditure Statement of the Life Companies

Many of these companies write both life and non-life business with the latter accounting for a substantial proportion of their total premium income.[17] While the present format by which insurers are required to make their annual returns to the Registrar does provide for a division in certain items, in respect of the two categories of business, for others the separation is not made, and even if the forms are adjusted, it is doubtful whether the company would be in a position to provide the data in this way.[18] For this reason we have kept both classes together, and our discussion would therefore focus on the aggregate data.

TABLE 3.12

EXPENSES (INCL. CLAIMS PAID) OF NON-LIFE INSURERS AS A % OF GROSS PREMIUM INCOME, 1971 – 1977

	Expenses/Charges	1971	1972	1973	1974	1975	1976	1977
1.	Commission Paid	20.8	23.0	21.9	23.1	22.0	20.3	22.0
2.	Refunds	0.4	0.8	1.0	2.3	0.3	0.1	0.1
3.	Reinsurance	4.6	4.3	8.1	6.4	10.0	14.2	9.5
4.	Claims Paid	49.2	35.6	37.7	37.4	45.4	45.1	38.0
5.	Local Manag. Expenses	1.1	2.3	3.5	6.1	7.5	7.7	6.5
6.	Manag. Exp. Charged to Bahamas Operations	6.1	6.5	4.1	4.1	4.4	3.0	5.3
7.	Increase in Reserve	6.0	6.1	5.3	1.5	0.8	–1.4	7.9
8.	Unearned Premium Reserve	31.2	36.4	36.7	38.9	38.5	32.6	31.4
9.	Other Expenses	0.5	0.3	2.3	0.8	0.1	0.8	0.8

Source: Table 3.10.

An examination of Table 3.13 shows that the life insurers, like the non-life companies, experienced a loss on their underwriting operations in each of the years between 1971 and 1977. Unlike the non-life group, however, a significant part of this loss was offset by the earnings from their investments which, on average, amounted to 13.7 per cent of gross premium income. When investment income and other accounting adjustments are taken into account, the net overall operation shows a positive result for all seven years, averaging about 10 per cent of gross premium income for the period. A point to note is that the results in any one year can be significantly influenced by provisions made for reserves and the life fund. These 'charges' tend to be affected by a number of factors against which any judgement on net performance has to be seen. Some of these relate to perceptions about the adequacy of existing levels of reserves in the context of changes in the social and economic environment, the rate of claims maturation and the volume of underwriting. With respect to the latter, it was pointed out earlier, a large part of the cost of underwriting occurs in the first year of the policy.

TABLE 3.13

OPERATING RESULTS OF LIFE INSURANCE COMPANIES,[a] 1971 – 1977

Year	(1) Gross Premiums $'000	(2) Under-writing Profits[b] $'000	(3) (2)[c] as a % of (1)	(4) Invest-ment Income $'000	(5) (4) as a % of (1)	(6) Overall Operating Results	(7) (6) as a % of (1)
1971	14,878	–448	3.0	1,675	11.2	1,869	12.6
1972	18,578	–1,435	7.7	2,078	11.2	1,371	7.4
1973	18,540	–631	3.4	2,625	14.1	2,599	11.9
1974	19,580	–1,258	6.4	2,919	14.9	2,251	11.5
1975	20,590	–1,777	8.6	3,266	15.9	2,665	12.9
1976	22,694	–3,166	13.9	3,350	14.8	827	3.6
1977	25,743	–2,239	8.7	3,680	14.3	2,392	9.3

a: Most of these companies are also engaged in non-life underwriting (e.g. accident and health).

b: Equal premium income less costs and claims.

c: In absolute terms.

Minus sign (—) indicates a loss.

Source: Table 3.9.

For the life operators, the pattern of relationship which expenses bear to premium income appears to differ in several respects from the non-life insurers as can be seen in Table 3.14. Particularly noticeable are items such as reinsurance, claims and unearned premium reserve, all of which tend to take a lower proportion of premium income in the life group. On the other hand, for expenses such as local management expenses, increases in reserves and other charges, the proportion is substantially higher. As far as trends are concerned, there is a great deal of fluctuation from year to year in the ratios for the various items. Commission takes about 18 per cent of gross premiums on average, as compared to 33 per cent for claims. The proportion for management expenses (item 5 and 6) seems to be increasing, moving from an average of 24 per cent in the 1971/73 period to an average

TABLE 3.14
EXPENSES (INCLUDING CLAIMS PAID) OF LIFE COMPANIES
AS A % OF GROSS PREMIUM INCOME, 1971 – 1977

Items	1971	1972	1973	1974	1975	1976	1977
1. Commission Paid	19.1	18.1	17.1	17.0	18.7	19.0	17.8
2. Refunds	1.6	1.2	2.8	1.8	1.7	2.9	1.5
3. Reinsurance	2.0	1.4	2.0	2.1	1.7	1.7	1.6
4. Claims Paid	32.4	31.4	32.7	33.3	33.3	32.5	35.6
5. Local Manag. Expenses	17.4	17.2	18.4	18.6	20.4	22.9	18.8
6. Manag. Exp. Charged to Bahamas Operations	6.6	5.7	7.4	7.5	6.8	6.6	7.2
7. Increase in Life Fund Reserves	19.3	26.9	16.9	18.2	22.8	26.1	22.3
8. Unearned Premium Reserve	0.7	1.4	1.6	1.0	1.1	1.2	1.1
9. Other Charges	3.7	4.2	4.2	6.8	1.8	1.1	2.7

Source: Table 3.9.

of 27 per cent in the 1974/77 period.

The major reason for the relatively lower reinsurance proportion for life insurers (as we pointed out earlier), is that these companies by the nature of their business, which normally involves a large number of small risks, are able to absorb most of the risks they underwrite. Claims thus generally tend to be more evenly spread than in the case of the non-life underwriter, where the amount paid out may fluctuate greatly from year to year. The unearned premium reserve, we indicated earlier, was peculiar to the non-life business and therefore merits no further comment.

The Efficiency of Life Insurance Companies

Before going on to discuss the assets portfolio of the insurance sector, there is a very fundamental point we need to make in respect of the expenses of life insurance companies. The level and growth of the expenses of these institutions do not only reflect their efficiency as business enterprises, but much more important from a community point of view, they reflect their efficiency as mobilisers of savings. This situation of course stems from the fact that not all the premiums collected by life companies can be regarded as savings. The portion paid as administration expenses, commission, wages, salaries, etc have to be treated as consumption.[19]

As indicated earlier, we do not have data which would permit us to make any observation on the evolving trends for the industry in the Bahamas over any great period of time. A look at Table 3.15, however, shows that in the seven years between 1971 and 1977, expenses[20] took on average, over 49 per cent of gross premiums. Even if we make our calculations on the basis of total income (i.e. gross premiums plus investment income) the proportion is still over 43 per cent (on average), which is higher than that of certain developed countries and not far behind developing countries like Jamaica and Trinidad which have a corporation tax.[21]

TABLE 3.15

EXPENSES[a] OF LIFE INSURANCE COMPANIES AS A % OF INCOME, 1971 TO 1977

Years	**Expenses as a % of Gross Premium Income**	**Expenses as a % of Total Income[b]**
1971	48.9	43.9
1972	46.7	42.0
1973	49.2	43.1
1974	52.0	45.2
1975	49.6	42.8
1976	51.2	44.6
1977	48.2	42.1

a: Commissions paid, local management expenses, head office expenses charged to local operations and other charges (which include office expenses, advertisements, etc.).

b: Gross Premium Income plus Local Investment Income.

Source: Table 3.9.

There are a number of factors which affect the cost of operation of an insurance company in any one year. As indicated earlier, the amount of new business written is an important one. The lapse and surrender rates (on which we have no available data on the Bahamas) will also tend to influence costs and hence net operating results. Since the writing of group business is associated with lower costs, this is a factor that can have a downward impact on the expense ratio. A final consideration is, of course, the scale of operation of the underwriting firm. A study[22] done on the United States life insurance business a few years ago, indicated that there was increasing returns to scale (decreasing costs) up to a premium level of $100 million after which the cost curve tended to level off indicating constant returns to scale. Compared to the companies in the more developed countries, the institutions in the Bahamas tend to be relatively small,[23] and because of this may find it difficult to reap the kind of economies and efficiency benefits that their counterparts in the larger and wealthier societies experience. However, an analysis of the 1973 data for life companies in the Bahamas indicate that even within the context of this narrow market, it may be possible to achieve greater economies which can no doubt result in more substantial benefits to the community. Dividing the companies into two groups, those with annual premium income of less than $2 million, and those with premium income of more than $2 million per annum, we found that the average cost per dollar of premium income for the former group was $0.51 as compared to $0.49 for the latter. The inverse relationship between size and average cost become more noticeable in an examination of the data relating to companies with a per annum income of less than $500,000. The average cost for this latter group was estimated to be $0.72, which was made possible by the high charges attributed by some companies to certain items (e.g. commission paid and local management charges) which, in some cases, were out of all proportion to the premium income received. Even if we calculate our cost ratios in relation to total income (i.e. gross premium income plus investment income), we get an average cost per dollar income of $0.47 for the group with annual premium income of less than $2 million, and $0.42 for the group with annual premium incomes of more than $2 million. The comparable average for companies with less than $500,000 per annum was $0.62.

While it is difficult to make firm statements on the basis of the above analysis or to draw conclusions about the optimum size of companies from the results, there is no doubt, given the varied factors that affect the average cost function, that there is scope for rationalisation of the industry and for improving its general efficiency.

The Local Assets Portfolio of Insurance Companies

Insurance companies belong to that group of institutions often referred to in the literature as the non-bank intermediaries. Besides acting as a depository for savings, they are also engaged in lending and investing activities which constitute an integral part of their operations as financial institutions.

In the Bahamas, corporations engaged in the insurance business form a significant part of the financial system. This can be seen to some extent from Table 3.16 which shows comparative assets figures for the major intermediaries at the end of 1978. The table (which does not include the foreign currency part of the institutions' portfolio), shows that at the end of 1978 the insurance sector with local assets amounting to $69.5 million or 14 per cent of total Bahamian dollar assets, ranked third to the commercial banks and the finance companies in terms of $B assets held by the institutions represented in the table.

For an industry that has been collecting an average of $33 million in premiums over the 1971–77 period, local assets of the order of $70 million is certainly not as large as they might have been under a different set of national policies. In a sense, therefore, it is somewhat misleading to evaluate the importance of a sector in terms of the size of its local assets, particularly where they relate to institutions which have enjoyed an almost unlimited freedom to remit funds abroad over the years.

Again, while assets data are generally useful in assessing the viability or solvency of an individual enterprise in terms of its domestic obligations, for a financial concern engaged in a continuous process of assets formation and liquidation, stock figures do not really convey a picture of the real importance of the role of these institutions in the economy. This statement becomes all the more true when it is considered that the acquisition or accumulation of fixed (or what some would call 'real') assets are not of intrinsic importance to the operations of financial institutions. Our discussion on the local portfolio of insurance companies that follows, therefore, is concentrated not so much on an examination of the magnitude of the figures involved as on the rationale for the behaviour reflected in the local disposition of resources and some of the consequences that flow from the existing pattern of resource use.

While there is a basic similarity in function between most financial institutions, there are certain differences which tend to set each type apart. The major dissimilarity between an insurance company and the rest lies not so much in the way it collects its funds – which is assured over a period of time – but in the nature of its liability. And here we have to make a distinction between life insurers or assurers and non-life companies. For while the business of the former is essentially a long term transaction, the contracts of the latter are more of a short term character.

> *In life assurance the individual risk is constantly increasing with time; in other branches its normal variability is negligible. As a consequence of this fact, life assurance represents a combination of risk cover and saving, while other branches are devoid of the saving character. In life assurance, savings for future needs are accumulating in the hands of the companies according to a particular system in an almost uninter-*

TABLE 3.16

A COMPARISON OF THE BAHAMIAN DOLLAR ASSET POSITION OF SELECTED FINANCIAL INSTITUTIONS AT THE END OF 1977

Financial Institutions	Bahamian Dollar Assets	
	$ m.	%
Commercial Banks	342.5[a]	66.7
Finance Companies	91.9	17.9
Insurance Companies	69.5[b]	13.5
Trust Companies	5.3	1.0
Post Office Savings Bank	2.0[c]	0.4
Penny Bank	2.4[d]	0.5
Total	**513.6**	**100.0**

a: Include foreign currency converted into Bahamian dollars.
b: End of 1977 position; figure includes some non-insurance assets.
c: At end of June, 1978.
d: At 30 March, 1979.
Source: Tables 2.3, 3.20, 3.21, 4.5 and 4.10.

> *rupted even flow, forming a quasi-permanent fund, which as a whole has no maturity date; it is like a cake which must always grow and should never be eaten. In other branches no similar funds are extant. Except in the case of a closed fund or of a company whose new business has been declining for some considerable time, the income of a life assurance office always exceeds its outgo. The problem is thus not one of realising assets to meet cash requirements, but of finding suitable investment outlets for large amounts of newly accumulating moneys.*[24]

The differences in the nature of the reserve funds of the two lines of business just outlined tend to have a critical influence on the type of assets selected for the portfolio of insurance operators. In the case of a life company, there are two factors which affect their investment behaviour. The first was mentioned in the last paragraph and that is the 'even flow' of funds which characterises this line of business. The second factor is the ability to predict, with a great deal of accuracy, the cash or liquid demand on the company. Both of these factors, combined with the nature of life contracts described earlier, allow this type of company to invest a high proportion of its reserves in long term investments.

With the general company, the policy contracts tend to be of a rather shorter duration than those involved in life underwriting, and this characteristic tends to be reflected in the investment selection of these institutions. The fact, too, that claims are more difficult to predict in this line of business tends to require a higher level of liquidity than that of a life company.

The Reserves/Assets Relationship

Before proceeding to a detailed discussion of the local assets of insurance concerns, we look briefly at some of the major factors that determine and influence their overall level. The most important item on the liabilities side of an insurer's balance sheet is what is termed the technical or actuarial 'reserves',[25] or in the case of a life underwriter the 'life fund'. The need for such reserves stems from the very nature of the business an insurance firm conducts, in which a significant part of the income derived in the present is intended to cover obligations arising in the future. To retain its solvency, therefore, an insurer, be it life or general, is forced to keep a pool of funds sufficient to meet commitments which may arise, depending on the type of business, with varying degrees of regularity. In the case of a life concern, the cash demand made upon it can be calculated with a high degree of precision (based upon mortality tables and accumulated information). This factor is of critical influence in determining the level of reserves of a life insurance company. A general company also has to keep reserves, but the required level at anytime is more difficult to predict, and this is manifested to a great extent (as we shall see later) on the composition of its portfolio of assets.

The items on the asset side[26] of the balance sheet show largely the areas in which the 'reserve' funds have been invested. The assets chosen vary from country to country, but, generally, the choice is influenced by a combination of yield, institutional constraints and, not least of all, the structure of liabilities of the firm. We will return to this subject again later in the discussion. For the moment we look briefly at the local assets/reserves relationship which is presented in Table 3.17.

The main point to emerge from this table is the fact that total Bahamas assets have been in excess of total policy reserves over the period. The ratio, however, appears to be declining, dropping from 154 per cent in 1971 to 131 per cent in 1977. This, of course, reflects the faster rate of growth experienced by reserves as compared to local assets. It is important

TABLE 3.17
LOCAL ASSETS AS A PROPORTION OF RESERVES, 1971 – 1977

B$'000	1971 (1) 'Life' & 'Life and Other than Life'	1971 (2) 'Other than Life'	1971 (3) All Groups	1972 (1) 'Life & 'Life and Other than Life'	1972 (2) 'Other than Life'	1972 (3) All Groups
1. Life Fund	21,368	–	21,368	26,694	–	26,694
2 Other Reserves	399	2,771	3,170	342	3,171	3,513
3. (1) + (2)	21,767	2,771	24,538	27,036	3,171	30,207
4 Bahamas Assets (as reported)	35,226	2,443	37,669	43,553	2,925	46,478
5. Bahamas Assets (as estimated)	26,102	2,443	28,545	32,626	2,925	35,551
6 (4) as a % of (3)	161.8	81.7	153.5	160.7	88.7	153.9
7. (5) as a % of (3)	119.9	81.7	116.3	120.7	88.7	117.7

	1973 (1) 'Life & 'Life and Other than Life'	1973 (2) 'Other than Life'	1973 (3) All Groups	1974 (1) 'Life & 'Life and Other than Life	1974 (2) 'Other than Life'	1974 (3) All Groups
1. Life Fund	30,247	–	30,247	32,854	–	32,854
2. Other Reserves	348	3,267	3,615	318	3,455	3,773
3. (1) + (2)	30,595	3,267	33,862	33,172	3,455	36,627
4. Bahamas Assets (as reported)	47,679	4,251	51,930	49,954	3,883	53,837
5. Bahamas Assets (as estimated)	37,151	4,251	41,402	40,404	3,883	44,287
6. (4) as a % of (3)	155.8	130.1	153.4	150.6	112.4	146.9
7. (5) as a % of (3)	121.4	130.1	122.2	121.8	112.4	120 9

Source: Returns to Registrar of Insurance, Bahamas

TABLE 3.17 Cont'd

	1975			1976		
	(1) 'Life' & 'Life and Other than Life'	(2) 'Other than Life'	(3) All Groups	(1) 'Life' & Life and Other than Life'	(2) 'Other than Life'	(3) All Groups
1. Life Fund	37,268	–	37,268	43,018	–	43,018
2. Other Reserves	375	3,552	4,302	383	2,898	3,281
3. (1) + (2)	37,643	3,552	41,195	43,401	2,898	46,299
4. Bahamas Assets (as reported)	55,041	3,943	58,984	58,474	3,772	62,246
5. Bahamas Assets (as estimated)	43,040	3,943	46,983	47,365	3,772	51,137
6. (4) as a % of (3)	146.2	111.0	143.2	134.7	130.1	110.4
7. (5) as a % of (3)	114.3	111.0	114.0	109.1	130.1	110.0

	1977		
	(1) 'Life' & Life and Other than Life	(2) 'Other than Life'	(3) All Groups
1. Life Fund	48,125	–	48,125
2. Other Reserves	687	4,046	4,733
3. (1) + (2)	48,812	4,046	52,858
4. Bahamas Assets (as reported)	64,448	5,030	69,478
5. Bahamas Assets (as estimated)	52,748	5,030	57,778
6. (4) as a % of (3)	132.0	124.3	131.4
7. (5) as a % of (3)	108.0	124.3	109.3

Source: Returns to Registrar of Insurance, Bahamas.

to note, however, that while this is essentially the trend to be observed with respect to the 'Life' and 'Life and Other than Life' group, Bahamas assets as a proportion of policy reserves for the exclusively non-life category have been increasing, moving from 82 per cent in 1971 to 124 per cent in 1977. It will be observed in the table that we have used two sets of figures for Bahamas assets. One relating to the data as reported by the companies, while the other is derived from an exercise intended to separate Bahamas located insurance assets from foreign investments (i.e. investments outside the Bahamas, some of which have been included in item 4) and local non-insurance assets.

Normally, insurance companies (for various reasons which we shall discuss later) tend to invest part of their reserves overseas, and it is important, from a policy point, to have some idea of the magnitude of this investment. Because of the ambiguity in the present reporting forms, however, certain companies include these assets, or a part of them (without explicitly stating so), while others do not. Some insurers have also adopted the practice of closely integrating their non-insurance business with their insurance operations, though the Insurance Act of 1969 calls for a strict separation of the two. The 'Life and Other than Life' companies are particularly guilty of this practice. Based on the inadequate details that are provided, we have estimated that the reported figures pertaining to Bahamas assets tend to be in the region of $10 to $12 million in excess of what would obtain if the requirements of the form were to be strictly adhered to. It is important to point out that whichever of the two concepts we use, the trends noted earlier would not be significantly affected as Table 3.17 clearly shows.

With respect to the proportion of annual increases in reserves that are invested in the Bahamas, the pattern is presented in Table 3.18. Increases in reported assets have exceeded increases in reserves in every year except 1974 and 1976. In the case of estimated assets, the exception years are 1975 and 1976. The relationship between movements in local assets and movements in reserves gives us an indication of the disposition of insurance resources between domestic deployment and foreign use. It can also provide us with an insight into the extent to which local investments are being financed by borrowing or by net earnings.

In drawing conclusions from the foregoing analysis, however, a note of caution should be sounded. While it may well be, as we have said earlier, that the relationships described may indicate that there are occasions when most or all the Bahamian policy reserves have been invested locally, this may not in fact be true of all insurers. We have to bear in mind that the discussion was concerned with the global or overall position of the insurance sector. It is quite possible that while some enterprises may be investing a substantial proportion, if not all of their reserves locally, others may be doing just the opposite, that is, sending most, if not all, their funds abroad for foreign employment.

TABLE 3.18

A COMPARISON BETWEEN MOVEMENTS IN LOCAL ASSETS AND RESERVES, 1972 TO 1977

Year	(1) Increase in Bahamas Assets Over Previous Year (a) Reported Assets	(b) Estimated Assets	(2) Increase in Reserves Over Previous Year	(3) (1a) –(2)	(4) (1b)–(2)
1972	8,809	7,006	5,669	3,140	1,337
1973	5,452	5,851	3,655	1,797	2,196
1974	1,907	2,885	2,765	–858	120
1975	5,147	2,696	4,568	579	–1,872
1976	3,262	4,154	5,104	–1,842	–950
1977	7,232	6,641	6,559	673	82

Source: Table 3.17

Composition of Local Assets Portfolio

We should, perhaps, introduce this section of the discussion by alluding to a point made earlier. That is some insurance firms in the Bahamas hold local assets that are in no way related to their insurance business[27] and they tend not to make a distinction when reporting to the supervisory authority.[28] This is worth bearing in mind even though we are able to identify, to some extent, the non-insurance component of the respective balance sheets.

As we have pointed out in respect of premiums, the distribution of local assets is also highly concentrated as can be seen in Table 3.19. At the end of 1977, the life companies held $64 million, or more than 90 per cent of total reported Bahamas assets. Of this figure, two companies alone were responsible for more than half, while the top nine insurers contributed 95 per cent to the total held by the group. As can be seen in the table, the 23 active non-life companies held local assets amounting to only $5 million, or less than 8 per cent of total reported assets. Three

TABLE 3.19

DISTRIBUTION OF BAHAMAS ASSETS OF INSURANCE COMPANIES[a] ACCORDING TO SELECTED CATEGORIES AT THE END OF 1977

	'Other Than Life'				'Life' and 'Life and Other Than Life'			
	Firms		Bahamas Assets		Firms		Bahamas Assets	
	No.	% Dist.	$'000	% Dist	No.	% Dist.	$ 000	% Dist.
Less than $ 500,000	206	87.0	2,288	45.5	7	39.0	1,351	2.1
500,000 – 1,000,000	2	8.7	1,451	28.8	2	11.1	1,583	2.5
1,000,000 – 2,000,000	1	9.3	1,291	25.7	–	–	–	–
2,000,000 – 5,000,000	–	–	–	–	6	33.3	20,594	31.9
5,000,000 – 10,000,000	–	–	–	–	1	5.5	7,618	11.8
10,000,000 – 25,000,000	–	–	–	–	2	11.1	33,302	51.7
All Categories	**23**	**100.0**	**5,030**	**100.0**	**18**	**100.0**	**64,448**	**100.0**

a: Active companies only

b: Six of these had no local assets whatever.

Source: Returns to Registrar of Insurance, Bahamas

companies accounted for more than half of this figure. The bulk of the non-life companies had assets amounting to less than half a million dollars each. In fact, six reported no local assets whatever.

It would appear from the above, that the composite companies (i.e. insurers doing both life and non-life business), seem to have a higher propensity to invest locally than the purely non-life operators. In practice, there might be several explanations for this. Firstly, the longer history of operation that the major composite companies have had in the Bahamas, has not only given them a larger slice of the market as can be seen in Table 3.19 (seven of the largest eight are composite), or endowed them with a greater familiarity with the local environment, but perhaps, most important of all, has allowed them to accumulate the funds necessary for engaging in activities which newer operators on the scene are unable to undertake. A second factor may stem from the fact, as we have pointed out earlier, that life companies tend, generally, to derive a higher proportion of their income from investments than non-life insurers and are thus more easily persuaded to employ a relatively higher proportion of their funds in the local market. A third factor and perhaps the most important of all, is, given the nature of its liabilities, the non-life company is constrained to avoid long term investments of the kind which a life operator can easily accommodate in its portfolio. A fourth reason is that, given the transitory character of its business, the non-life company tends to be less committed to the country of operation than the life underwriter, thus accounting for its marginal interest in local assets of social value.

A discussion of the major items in the local portfolio now follows. Table 3.20 and 3.21 present the structure of local assets held by insurance companies for the years 1971 to 1977. Over this period, the total Bahamas assets of the non-life group increased from $2.4 million to $5.0 million, or by 108 per cent. The corresponding figures for the life companies were $35.2 million in 1971 and $64.4 million in 1977 – an increase of 83 per cent. Excluding the non-insurance assets (which incidentally are included in the item 'Other Assets' in Table 3.20), the growth might be even less impressive. The following paragraphs are devoted to a discussion of the factors influencing the disposition of the resources generated by insurance companies in the Bahamas and the general framework of their investment operations:

> *Broadly speaking, investments may be divided into two distinct groups. One comprises investments representing ownership (real estate, shares and stocks), while the other represents public and private debts (bonds of governments and their sub-divisions and of private corporations, loans on policies, life interests and reversions, etc.). In the normal composition of an insurance company's investments those of the first group will, as a rule, represent a small proportion only.* [29]

Applying this analysis to Table 3.20, it will be observed that the share of the ownership category in the total for the non-life group was around 1 per cent, while for the life companies the figure was 10 per cent in 1977. It should be pointed out that at the level of an individual enterprise, this may not be the general pattern, and that it is probable the overall position has been greatly influenced by the investment policies of a few companies.

Government Securities

Until 1974 when Government made its first stock offer, Treasury Bills were the only other government paper available to investors. As is well known, this latter instrument is essentially a means to facilitate Government's short term borrowing, but also serves the useful purpose of providing a medium for institutions seeking a relatively liquid investment opportunity. Because of the nature of their liabilities, insurance companies

TABLE 3.20

COMPOSITION OF LOCAL ASSETS OF 'LIFE' AND 'LIFE AND OTHER THAN LIFE' COMPANIES, 1971--1977

	Local Assets Portfolio	1971		1972		1973		1974	
		$'000	%	$'000	%	$'000	%	$'000	%
1	Securities or Investments Guarangeed by Bahamas Government	45	0.1	133	0.3	600	1.3	730	1.5
2.	Mortgages	12,544	35.6	14,146	32.5	15,397	32.3	17,670	35.4
3.	Land/Buildings	5,753	16.3	6,658	15.4	6,337	13.3	6,406	12.8
4.	Loans on Life Policies	2,766	7.9	3,330	7.6	3,601	7.6	4,297	8.6
5.	Cash and Receivables	3,324	9.4	3,333	7.6	4,640	9.7	5,657	11.3
6.	Due from Agents and Insureds	513	1.5	602	1.4	498	1.0	539	1.1
7.	Other Assets[a]	10,281	29.2	15,351	35.2	16,606	34.8	14,655	29.3
	Total Bahamas Assets	**35,226**	**100.0**	**43,553**	**100.0**	**47,679**	**100.0**	**49,954**	**100.0**

	Local Assets Portfolio	1975		1976		1977	
		$'000	%	$'000	%	$'000	%
1.	Securities or Investments Guaranteed by Bahamas Government	680	1.2	1,804	3.1	1,109	1.7
2.	Mortgages	18,873	34.3	20,873	35.7	22,417	34.8
3.	Land/Buildings	6,406	11.6	6,187	10.6	6,354	9.9
4.	Loans on Life Policies	4,958	9.0	5,779	9.9	6,484	10.1
5.	Cash and Receivables	5,653	10.4	6,497	11.1	8,099	12.5
6	Due from Agents and Insureds	469	0.8	821	1.4	629	1.0
7.	Other Assets[a]	18,002	32.7	16,513	28.2	19,356	30.0
	Total Bahamas Assets	**55,041**	**100.0**	**58,474**	**100.0**	**64,448**	**100.0**

[illegible] outstanding premiums bonds, stocks, investments in subsidiaries and loans to affiliates

TABLE 3.21

COMPOSITION OF LOCAL ASSETS OF 'OTHER THAN LIFE' COMPANIES, 1971 TO 1977

Local Assets Portfolio	1971		1972		1973		1974		1975		1976		1977	
	$'000	%	$'000	%	$'000	%	$ 000	%	$ 000	%	$'000	%	$'000	%
1. Securities or Investments Guaranteed by Bahamas Government	—	—	—	—	49	1.1	150	3.9	173	4.4	100	2.6	—	—
2. Mortgages	—	—	—	—	—	—	—	—	—	—	—	—	—	—
3. Land/Buildings	67	2.7	70	2.4	34	0.8	81	2.1	70	1.8	58	1.5	66	1.3
4. Cash & Receivables	359	14.7	411	14.1	660	15.5	1,459	37.6	1,435	36.4	1,821	48.3	2,283	45.4
5. Due from Agents & Insureds	1,187	48.6	1,183	40.4	1,958	46.1	1,201	30.9	1,497	37.9	1,038	27.6	2,430	48.3
6. Other Assets	830	34.0	1,261	43.1	1,550	36.5	992	25.5	768	19.5	755	20.0	251	5.0
Total Bahamas Assets	**2,443**	**100.0**	**2,925**	**100.0**	**4,251**	**100.0**	**3,883**	**100.0**	**3,943**	**100.0**	**3,772**	**100.0**	**5,030**	**100.0**

Source: Returns to Registrar of Insurance, Bahamas.

generally tend to prefer higher yielding and, therefore, longer term avenues in which to channel their funds. This may partly explain why Treasury Bills have traditionally accounted for such a small part of their total investment. An important factor has also been the question of supply, i.e. not enough to meet the demands of competing investors in a situation with a narrow range of investment outlets.[30]

In recent years, with the issue of long dated securities, an increasing volume of insurance resources has been placed at the disposal of the Government, even though the share in the total portfolio has shown a tendency to fluctuate from year to year. The data appearing with respect to investment in government securities in Tables 3.20 and 3.21 do not give a fair indication of the volume of funds disposed through this medium. According to figures published by the Central Bank, the insurance companies' share of the Bahamas government registered stock and other securities (Bahamian dollars) increased from $0.8 million (5.8 per cent of total outstanding) at the end of 1973 to $6.3 million (7.3 per cent of total) at the end of 1977, and $8.2 million at the end of 1978.[31]

Mortgages

For a variety of reasons, yields being not the least of them, mortgage lending (i.e. loans secured by real property) is particularly attractive to life insurance companies. The major explanation for this, of course, lies in the fact that they are better equipped than most other institutional lenders to engage in this type of activity. Unlike in the banking business, for instance, where the institution-client relationship is basically a short term one, and where deposits are constantly moving up and down, insurance operation is characterised by a more secure relationship which virtually guarantees the income of the insurer over a long period. The inflow of funds is not subject to great fluctuation, and because calculation of claim liabilities can be quite accurate, and operating expenses can be closely estimated, liquidity is of less importance to life insurance companies than to other types of institutional lenders.[32]

An examination of Table 3.20 will show that the volume of mortgages outstanding increased from $12.5 million (35.6 per cent of the reported assets of the life companies) in 1971 to $22.4 million (34.8 per cent of reported assets) in 1977. For reasons indicated earlier, the non-life companies do not favour mortgage loans as an investment outlet.

There is no set figure which can be advanced as the ideal proportion for mortgages in an insurer's assets portfolio. Since the factors[33] affecting this relationship vary over time and from place to place, so too, can one expect variation in the mortgages/assets ratio over time and from country to country. The amount of mortgage activity undertaken in relation to total investments will also tend to vary from company to company, reflecting a pattern of asset preferences in which local conditions and constraints may play only a small part. A glance at Table 3.22 will give us some

TABLE 3.22

PARTICIPATION OF INSURANCE COMPANIES IN MORTGAGE LENDING AND MORTGAGES OUTSTANDING AS A PROPORTION OF REPORTED BAHAMAS ASSETS, 1977

Firm	(1) Mortgages Outstanding (a) $'000	(b) % of total	(2) Reported Bahamas Assets $'000	(3) (1a) as a % of (2)
1	12,236	54.6	22,308	54.8
2	3,645	16.3	7,618	47.8
3	2,494	11.1	10,994	22.7
4[a]	1,852	8.3	2,240	82.7
5	1,246	5.6	3,570	34.9
6	448	2.0	4,059	11.0
7	347	1.5	902	38.5
8	124	0.5	4,178	3.0
9	25	0.1	4,346	0.5
Total	**22,417**	**100.0**	**60,215**	**37.2**

a: This firm is essentially a mortgage lender doing its own underwriting.

Source: Returns to Registrar of Insurance, Bahamas

idea of the depth of participation of insurance companies[34] in mortage activities. Of the total outstanding at the end of 1977, one company alone accounted for more than half. Six[35] were responsible for 96 per cent. As a proportion of reported Bahamas assets, mortgages outstanding vary from less than 1 per cent to over 80 per cent. If the non-insurance assets are excluded from the figures for certain firms, the proportion would obviously be higher in some cases.

At present, the data collected does not provide a breakdown of the main areas in which funds are being lent, and therefore, we are not in a position to say very much about the distribution of outstandings between the residential, commercial and industrial sectors. From interviews, however, it has emerged that the residential sector of the market has been the fastest growing over the last few years, and it is in this area that most mortgage loans are currently being made.

It would appear that with a few exceptions, insurance companies in the Bahamas generally are not inclined to put their resources into mortgages. Even for the majority of those that do, this type of investment represents only a small part of their total local assets. One does not expect a firm to violate all the canons of prudent business and direct all its funds into one area – however important that might be from other viewpoints. An essential aim is to obtain a balance in its portfolio consistent with the profitability and security principles, and most important of all, with the structure of its liabilities. However, within this framework there must be a commitment to assisting and developing the community in which it operates and from which it derives its resources and income. At a period in the country's development when there is a crying need for mortgage funds, insurance companies generally, as a major source of this type of finance, are not playing their part as well as they might. Table 3.23 shows that at the end of 1978, of $145 million in Bahamian dollar mortgage loans outstanding, the insurance sector accounted for less than 16 per cent. The commercial banks which are supposed to be essentially short term lenders appeared to have accounted for more than twice this proportion. The latter institutions also do a certain amount of lending in foreign currency.

Loans on Life Policies

By definition, this is an item which is found only on the balance sheets of life insurers. "A life insurance policy almost invariably carries the right, or at least the claim to an advance on its proceeds within the cash surrender value at the time . . . In commercial practice these advances on the accumulated savings of the insured are called policy loans and are carried among the assets as investments".[36]

Though technically these loans are part of the company's assets, they have a peculiar status. Unlike a banking institution, the company has no power to call in the loan, which, in fact, is more in the nature of a withdrawal of savings by the policy holder than a lease on someone else's resources. "When a claim occurs under the policy, the loan will be offset against the proceeds of the policy underlying the transaction, if it has not been repaid voluntarily before a claim arises. Policy loans cannot be used to meet general liabilities if a company fails. In such a case those who took out a policy loan are in a position of previleged creditors".[37]

From what we have said above, it is clear that the making of policy loans is an integral part of the life insurer's business. True, he can probably survive, and maybe do very well without this aspect of his operation; in fact it is often argued that the high interest rates associated with this type of loan is intended to discourage borrowing on policies. On the other hand, a policy loan, as we have described it above, is virtually a riskless investment.

TABLE 3.23

PARTICIPATION OF FINANCIAL INSTITUTIONS IN THE LOCAL MORTGAGE MARKET
(Position at End of 1978)

Financial Institutions	Bahamian Dollar Loans Outstanding		Foreign Currency Loans to Residents Outstanding	
	$m.	%	$m.	%
Finance Companies	67.6	46.5	–	–
Commercial Banks	54.0[a]	37.2	35.9[a]	98.5
Insurance Companies	22.4[b]	15.4	–	–
Trust Companies	0.5	0.3	0.5	1.4
Penny Bank[c]	0.8	0.6	–	–
Total	**145.3**	**100.0**	**36.4[d]**	**100.0**

a: Figures represent outstanding balances of loans and advances made to the 'real estate' and 'building and construction' sectors. Exactly what proportion of this total was on mortgage basis is not known, though it seems safe to assume that a substantial part was of this form.

b: End of 1977 position.

c. Position at 30/3/79.

d: Excluding data from insurance companies, which are not believed to be of any significance.

Source: Tables 2.14, 2.15, 4.2, 4.10 and 4.14.

A glance at Table 3.20 shows that policy loans have been increasing both in absolute terms and as a percentage of reported Bahamian assets in recent years. The figure moved from $3.6 million (7.6 per cent of assets) at the end of 1973 to $6.5 million (10.1 per cent of assets), at the end of 1977. This would indicate a relatively faster growth than investment in some other areas.

Real Estate Investment

One of the most attractive features of this type of investment is its ability to hold and even to increase its value in a situation of rising prices. For this reason, insurance companies, both life and non-life, generally tend to carry a proportion of their assets in this form, notwithstanding the low returns and difficulties often associated with real property holdings.

The amount of its funds which a company invests in real estate is, in some cases, a matter of choice, but more often than not is dictated by the character of the company's obligations and/or the existence of legal regulations in the country of operation. In the case of a life company for instance, whose liabilities are essentially of a nominal nature, there is no compulsion to acquire real assets to compensate for losses affected by increasing prices, since the amounts to be paid in the event of death or policy maturity are generally fixed at the time the contract is initiated. For a non-life insurer on the other hand, whose liabilities are not fixed in nominal values, the need to invest in real property as a means of off-setting the impact of increasing prices is a more urgent one, particularly if the alternative measure of increasing premiums in line with prices, is not feasible.

Broadly speaking, the real property assets of an insurance company can be divided into three groups as follows: (a) the premises from which it conducts its business; (b) property held for rent; and (c) temporarily held real estate acquired for speculative purposes, or as a result of mortgage foreclosure.

Because of the highly 'illiquid' nature of this type of investment, there are regulations in some countries governing the amount of real estate (apart from office accommodation) which a company may hold at any time. In the Bahamas there is no such requirement.

Other Assets

The only other item in Tables 3.20 and 3.21 on which we need to make some comment is that of 'other assets'. While in 1977 this item accounted for only 5 per cent of the total assets of the non-life insurers, the figure for the life group was in the region of 30 per cent. In the case of the latter, as indicated earlier, the size of the figures are affected by the inclusion of non-insurance assets. The main components are outstanding premiums, investments in subsidiaries, loans (other than policy) and securities. From the data available to us it would appear that the last component has been among the fastest growing of all over the last few years. Securities represent a type of investment to which insurance companies generally are greatly attracted, and in some countries they provide a significant proportion of the funds industry raises in this way. In the Bahamas, some insurers have expressed disillusionment over the fact that not enough equity has been forthcoming from local companies, and even when this does take place, as happened recently in one case, special care is taken to see that the issue accrues to hand-picked recipients.

Investment Regulations

In the Bahamas, as we have stated before, there are no specific regulations governing the investments of insurance companies. The one clause in the legislation that refers to this subject is a very general one and reads as follows. "The Minister may require that a registered local insurer shall not make investments of a specified class and may in that case require such insurer to realise investments of that class within a specified period".[38]

In a great many countries,[39] however, the governments, in the interest of development and protecting local policy holders, have gone further and laid down specific guidelines to regulate the investments of insurance concerns, particularly that part relating to technical reserves. In Argentina, for example, life companies are required to hold at least 10 per cent of their assets in public bonds, while the corresponding figure for non-life insurers is 25 per cent. At the same time, in respect of mortgages (first degree), there is a maximum of 60 per cent for the latter group and 80 per cent for the former. One regulation in the Columbian legislation requires that no less than 15 per cent of the assets of non-life companies should be invested in mortgage loans for low-cost housing. It should be noted that in respect of certain types of assets, some countries have been merely content to list them as 'eligible' without stipulating any maximum or minimum proportions to be held. Among such assets one can find Treasury Bills, certificates issued by mortgage companies, shares of development banks, etc. As far as investment in foreign assets is concerned, several countries (e.g. Brazil) do not permit this, and some of those that do, are moved to do so only under special circumstances, or up to a certain limit.

Besides the regulations pertaining to the acquisition of assets, a great many states, in a further effort to secure policy-holders, have laid down specific bases for the calculation of the various types of reserves which in some cases are also subject to explicit investment regulation. While, for example, the authorities in most countries permit the companies to use their own methods in calculating their mathematical reserves, only specifying the need for such reserves, some (particularly Latin American and African states) go a step further and lay down precise procedures in evaluating reserves for unexpired risks and outstanding claims. The requirement for the former is normally posited as a percentage of annual premium, while that pertaining to the latter is often left to coincide with estimated claims.

Bahamas Liabilities of Insurance Companies

Apart from commission payable, policy reserves and the life fund, the reporting form provides no other details on the Bahamas liabilities of insurance companies. All other items are placed in the category 'other liabilities' which appear to include non-insurance liabilities as well. From the details provided by a few companies, the major components are home office accounts, amounts due to policy holders, claims outstanding, loans due to parent company, amounts due to subsidiaries and proposed dividends. Even when all these are taken into account, however, the largest single item in the liabilities structure is policy reserves (See Table 3.24). For the life companies the proportion has been averaging around 74 per cent in the 1971–77 period, though the ratio appears to have been increasing in the later years. As far as the non-life insurers are concerned, policy reserves

TABLE 3.24

POLICY RESERVES OF LIFE AND NON-LIFE COMPANIES AS A PERCENTAGE OF TOTAL (REPORTED) BAHAMAS LIABILITIES, 1971--1977

Years	(1) Total Liabilities	(2) Policy Reserves[a]	(3) (2) as a % of (1)	(4) Total Liabilities	(5) Policy Reserves	(6) (5) as a % of (4)
1971	29,585	21,767	73.6	5,368	2,771	51.6
1972	40,537	27,036	66.7	5,876	3,171	53.9
1973	43,103	30,595	71.0	6,545	3,267	49.9
1974	46,050	33,172	72.0	7,827	3,455	44.1
1975	48,982	37,643	76.8	7,774	3,552	45.7
1976	54,551	43,401	79.6	6,842	2,898	42.3
1977	60,503	48,812	80.7	10,037	4,046	40.3

a: Including life fund.

Source: Returns to Registrar of Insurance, Bahamas.

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seem to form a smaller proportion of total liabilities. Unlike the life companies the ratio for this latter group appears to have been declining in the 1971–77 period, moving from 51.6 per cent in 1971 to 40.3 per cent in 1977.

The Bahamian Owned Concerns

When the Insurance Act of 1969 was passed, there were six Bahamian owned insurance companies in operation in the Bahamas. These institutions were established at various points in time between 1944 and 1968. All of them appeared to have been set up with the purpose of doing industrial life underwriting, though a certain amount of general business was undertaken in the course of time. Since the late '60s, a number of changes have taken place. The licence of one company was revoked in 1973. Another underwent a change of name and organisation in 1974, while a third was acquired by one of the other Bahamian owned insurance institutions in early 1979. At the time of writing, therefore, there were four locally owned firms in the underwriting business.

Because of the difficulty in obtaining up to date figures for two companies, we have had to make estimates on the basis of available data in order to derive certain aggregates which could enable us to put the Bahamian owned sector in perspective. As shown, in Table 3.5, the locally owned enterprises (all of which, as we said earlier, are engaged in both life and general insurance business) collected about $4.8 million in premiums in 1977, or about 12 per cent of the overall total. In terms of assets, together they held about $4 to $5 million, or about 6 per cent of total reported Bahamas assets. With one exception, the locally owned firms are relatively insignificant. In 1977, this one insurer contributed over 70 per cent of total premiums of Bahamian enterprises and over 80 per cent to their combined reported assets.

Composition of Assets

Between 1971 and 1977 local assets of the Bahamian insurers increased by about $2.4 million or by 172 per cent in current dollars. Concomitant with this growth, there were one or two significant changes taking place with respect to the disposition of resources over the period. While no government securities were held in 1971, investment in this area amounted to 4 per cent of total assets in 1977. Policy loans continue to remain small, accounting for around 1 per cent of the total. 'Other loans' increased its share slightly over the period while the category relating to land and buildings dropped from 29 per cent in 1971 to 25 per cent in 1977. The cash proportion also fell noticeably. The most significant change, however, seems to have occurred with respect to mortgage lending. While the locally owned companies were hardly making such loans in 1971 (2.3 per cent of assets), by 1977 the share of this item in total assets was 32 per cent.

Though these figures have no doubt been influenced by the activities of the biggest company in the group, it is worthwhile to speculate on reasons for this development. The way an insurance company disposes of its resources has not only an effect on its ability to compete in terms of the level of premiums it can offer prospective clients, but it also has social implications from the community's point of view. Against the need for liquidity to meet expected claims, an insurer has, of necessity, to reconcile this requirement with the other internal objective of achieving a mix in his portfolio, consistent with at least an operationally acceptable rate of return,[40] if not with the maximum possible in the circumstances. Environmental constraints can often force a disposition which is inconsistent with this latter objective. The same could, of course, also happen with inadequate internal organisation and deficient management able to achieve and maintain the desired balance in the portfolio of assets.

The relatively large build up of cash until 1973 (when some of it began to be loaned out in mortgages) may have been the result of an excessive concern with liquidity. It may also have been the result of dissatisfaction

TABLE 3.25

COMPOSITION OF LOCAL ASSETS OF BAHAMIAN OWNED COMPANIES, 1971 AND 1977[a]

	Bahamas Assets	1971 (6 Cos.)		1977 (3 Cos.)[b]	
		$'000	%	$'000	%
1.	Securities or Investments Guaranteed by Bahamas Government	–	–	145	3.6
2.	Other Securities	405[c]	27.8	208	5.2
3.	Mortgages	34	2.3	1,251	31.6
4.	Policy Loans	10	0.7	43	1.1
5.	Other Loans	236	16.1	733	18.4
6.	Land/Buildings	421	28.9	973	24.5
7.	Cash	147	10.1	185	4.6
8.	Due from Agents and Insureds	6	0.4	--	–
9.	Other Assets	198	13.7	436	11.0
	Total Assets	**1,457**	**100.0**	**3,974**	**100.0**

a. Figures for the various companies reflect position at the end of their respective accounting periods which do not necessarily coincide either with each other, or with the calendar year.

b: Figures for two of the smaller companies were not available.

c: Includes investments in associated companies.

Source: Returns to Registrar of Insurance, Bahamas.

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with the rate of return on mortgage loans. There was certainly no shortage of demand for this type of funds in the late '60s/early '70s. Another factor may have been that the companies did not feel sufficiently secure, or were not geared to enter this type of activity, and it was only strong government prodding that may have led to the eventual decision to enter the field. Or, finally, the rate of return may have increased sufficiently to induce greater commitments of funds from other investments.

Some Concluding Observations on Locally Owned Firms

With but two exceptions, the Bahamian owned enterprises have found it extremely difficult to maintain a viable business operation in recent years. The inability to capture a larger share of the insurance market, reflects basically a lack of competent accounting and management skills which are essential in a competitive and relatively sophisticated situation. The conditions that prevailed when these companies were formed have changed so dramatically over the years that without the willingness to institute changes and adapt to changing circumstances, survival is virtually impossible. One cannot hope to run a cheap operation at the expense of efficiency, and at the same time attract the kind of business necessary for expansion and development. It is worth noting in this connection that only one of the Bahamian owned enterprises — and this is one of the youngest of the lot[41] — has dared to venture into overseas markets.[42] While a number of foreign concerns have found it advantageous to use the Bahamas as a base from which to conduct their overseas operations, it seems paradoxical that the Bahamian enterprises should be content to confine their activities to the home front, and, thus, lose the fiscal benefits offered by their country's financial arrangements.

It has been convincingly demonstrated by one firm,[43] that a well organised and effeciently managed concern, is capable of competing with the big multinational operations which often have expertise and resources at their disposal far greater than anything a local concern can hope to muster. It is surprising, therefore, that more Bahamian enterprises have not emerged to take greater advantage of what seems to be an extremely lucrative market. Some of the existing local concerns are clearly unwilling or unable to assume a greater role in the domestic insurance business. One inhibiting factor appears to be lack of capital resources. The Insurance Act of 1969 stipulates that any "registered insurer doing a life insurance business shall have a paid-up share capital, or equivalent surplus, if a mutual company, of three hundred thousand dollars".[44] Since it was known that some of the locally owned enterprises could not meet this requirement at the time the Act was passed, and to avoid the political repercussions that their closure might have generated, another clause was included which granted a period of grace to existing insurers "provided that the insurer presents a satisfactory plan to the Minister for increasing the capital or surplus to the amount of one hundred thousand dollars in not more than five years."[45] At the end of 1977, only one company had a paid-up capital of $300,000, while the figures for the others ranged between $30,000 and $150,000.

A final observation on the question of minimum capital resources is worth making. The over-riding objective of the Insurance Act of 1969 was to enhance the Bahamas as a haven for reputable firms wishing to engage in genuine business activity. In the years immediately preceding the passing of this Act, a number of incidents, particularly relating to banking and insurance, had severely tarnished the image of the Bahamas as a centre for legitimate financial activity. In this period of what can be aptly called unregulated insurance underwriting,[46] it was possible with as little as $60.00 to form an insurance firm and then present it abroad as a duly incorporated Bahamian or British company. "Asked by the Insurance Commission (US), to produce a certificate of holdings, this same company would then incorporate a bank in the Bahamas and issue itself a phoney certificate. The Commission would accept the certificate in good faith and the fraud company would be free to operate for two or three years,[47] collect the premium and then disappear".[48] In 1967, it was estimated that there were over 300 insurance companies on the registry records, as compared to 85 at the end of 1973 and 64 at the end of 1977.

A principal purpose of the Insurance Act of 1969 was to eliminate these fraudulent operators which it clearly succeeded in doing by requiring minimum paid-up capital resources. It is to be noted, however, that the Act does not call for the formation of locally incorporated offices. In other words, insurers constituted abroad with capital equal to or greater than the local minimum can operate in the Bahamian market via agencies or branches without putting up any further finances. From the point of view of viability and insured's protection there may be nothing wrong with this arrangement. From the point of view of encouraging local enterprise, however, there is clearly an element of discrimination which militates particularly against organisations with a limited business horizon; for, given the size of the legal minimum capital requirements, an organisation would have to aim at achieveing a sizeable business to avoid over-capitalisation and bring a reasonable return on invested funds.

This dilemma, it should be stated, is by no means peculiar to the Bahamas. In the context of their development efforts and their desire to localise their economies, many developing countries have faced this problem in trying to institute insurance legislation with the aim of protecting the public. One approach being used by Ghana and Kuwait is to discriminate against foreign concerns by stipulating lower minimum capital for domestic companies. Neither of these countries, however, requires the local investment of the share capital.[49] The lower capital requirements, it should be noted, can be compensated for by stricter insurance supervision and the provision of technical assistance aimed at developing viable and dynamic enterprises which could gain the confidence of the public. Besides the level of the share capital requirement as it concerns local and foreign firms, there is another aspect to the capital issue, and this arises from the awareness

> *that the share capital of a foreign company serves as a guarantee for many commitments, often spread over a large number of countries and that it therefore escapes local insurance supervision. For this reason, Mexico's insurance law does not allow foreign concerns to advertise the capital and overall resources at their dis-*

> *posal, but only the resources which are actually in the country and are directly allowed to cover liabilities contracted there.*[50]

In the Philippines, while a minimum share capital is required of domestic companies, foreign concerns have to make a statutory deposit as a guarantee for business transacted there.

As the above clearly shows, there is no single approach to the question of capital requirements for insurance companies. In most countries which have introduced legislation in the postwar period, the main objectives have been to protect the public and to divert resources to certain areas of the economy. It is becoming increasingly clear, however, that legislation — and particularly financial legislation — has a critical part to play in the development effort, and for this reason it has to be formulated not only within the framework of broader economic policies of the particular country concerned, but in relation to specific objectives which clearly appear to be in the interest of the country. Failure to adopt this perspective may only serve to perpetuate a state of affairs which is in direct conflict with the nation's long term development goals.

Insurance and the Balance of Payments

For purposes of the balance of payments, insurance transactions can be classified broadly into two groups: (a) those connected with commerce; and (b) those related to the protection of life and property.

(a) Merchandise Insurance

The expressions c.i.f. (cost, insurance and freight), c.& f. (cost and freight), f.o.b. (free on board), and f.a.s. (free alongside ship), are terms that are closely associated with the conduct of international trade and are to be found invariably in the accompaniment of trade data as a qualifying element indicating the content of the figures. The terms are generally used to describe the conditions of sales or purchases and the intention is "to fix beyond dispute, the responsibility for the various costs and risks involved in the transport function".[51] For example, when goods are bought c.i.f. it is the exporter (seller) who arranges for the insurance and transport of the merchandise, the cost for which is added on to the price of the products. On the other hand, where a sale is agreed to under f.o.b. conditions, the importer (buyer) takes responsibility for arranging insurance and shipment. One effect of these terms is to determine the location of choice of the means of transport and often the insurer as well.[52] And this means, therefore, that countries that buy c.i.f. and sell f.o.b., as do most developing countries, lose a great deal of foreign exchange through payment of insurance and freight charges on their international trade. For countries without the necessary insurance and transport facilities, however, the terms of sales or purchase do not really matter since the business will revert back to a foreign enterprise, although the possibility of obtaining lower service charges exists in a situation which permits a choice in carrier or insurer. On the other hand, for a country that does possess the facilities, or is in the process of building them up, the conditions under which merchandise transactions are carried out are especially important if national enterprises and the economy are to derive some benefit from the conduct of that country's foreign commerce.[53]

As Table 3.26 shows, the Bahamas, like a great many developing countries, earns no foreign income from the carriage or insurance of its international trade. In the nine-year period between 1970 and 1978, this country paid out $191.7 million in freight and insurance.

(b) Insurance of Life and Property

For the developed countries, the services, particularly the insurance and transport business, are significant foreign exchange contributors to their balance of payments and ultimately to their national development. In its 1973 Annual Report, the Crown Life Insurance Company of Canada reported as follows:

> *Over the last few years life insurance has become one of Canada's most important exports. In fact, Canada today ranks as the world's leading exporter of life insurance products. In 1972, Canadian life insurance companies exported more than $6.5 million worth of life insurance products bringing total ownership of Canadian policies outside the country to $38 billion (held by 2 million policy owners in over 30 countries).*[54]

For Britain too, the importance of the insurance business as a foreign exchange earner has also been growing. In fact, insurance is the largest contributor (42.2 per cent in 1977) to foreign earnings accruing from the export of financial services. In absolute terms its contribution grew from £75 million in 1967 to £575 million in 1977. The comparable figures for banking was £26 million in 1967 and £293 million in 1977.[55]

For the vast majority of developing countries, however, the insurance business, which is generally dominated by foreign concerns, makes little or no positive contribution to their balance of payments. If anything, in most cases it acts as a drain on their foreign exchange reserves[56] – a problem that will be examined a little later. To the extent that locally owned firms can win a larger share of the domestic insurance market, this will, no doubt, have an effect on the outflow of funds. To earn foreign exchange, however, the locally based companies will have to operate outside their home limits since most countries prohibit their residents from insuring their lives or property with insurers outside the state, except in circumstances where the coverage sought is not available locally. Evidence available indicates that even in situations were domestic companies have been established, these (for various reasons), have not been particularly successful in expanding their operations abroad.[57]

Turning our attention to the kind of insurance transactions that give rise to inflows and outflows of foreign exchange, it should be pointed out that

TABLE 3.26

BAHAMAS' RECEIPTS AND PAYMENTS OF FREIGHT AND MERCHANDISE INSURANCE ON INTERNATIONAL TRADE, 1970 – 1978

$ m.

Year	Receipts	Payments
1970	–	22.4
1971	–	19.6
1972	–	19.0
1973	–	22.1
1974	–	23.6
1975	–	17.3
1976	–	20.9
1977	–	21.8
1978[a]	–	25.0

a: Provisional.

Source: Central Bank of the Bahamas, *Quarterly Review*, various issues.

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the exchange control regulations in no two countries are identical. From this, it follows that foreign exchange transactions that may be permitted by one country may be illegal or forbidden in another. Generally, however, some of the items that give rise to movements of funds across national frontiers can be summed up as follows:[58]

Inflow	Outflow
1. Premiums for Coverage Sold Abroad	6. Management Expenses
2. Payment of Claims or Losses	7. Profits, Interest, Dividends and Rent
3. Profits, Interest, Dividends and Rent	8. Premiums (for Coverage not Available Locally)
4. Sales of Foreign Assets	9. Investment of Reserves
5. Reinsurance	10. Payment of claims to Foreign Policy Holders
	11. Reinsurance

The items listed above as insurance transactions which affect the balance of payments are to a large extent self-explanatory. However, with respect to some of them a few comments should be made, against the background of the situation prevailing in the Bahamas.

Since domestic insurance companies do not write any significant overseas business items (1), (3) and (10) which essentially arise from this pattern of operation are not of any great importance. Item (9) is made possible by the fact that the Bahamas has no formal regulations governing the disposition of reserve funds which can be invested locally or abroad. As for (8), the foreign exchange authorities do not normally permit residents to seek cover abroad other than for risks which domestic insurers are unwilling or unable to assume. Such an instance arose in 1970 in the Freeport area where local insurers were unwilling to provide insurance for motor vehicles on which they complained they were experiencing heavy losses. An article appearing in the Nassau Guardian and Bahamas Observer of 9 November, 1970, reported as follows:

> *All Banks and finance companies insist that cars bought on a hire-purchase agreement be comprehensively insured. They have therefore been obliged to arrange coverage either in Nassau or the U.S.A.*
> *Coverage on these cars bought on hire purchase agreements are usually arranged by the bank, finance house or the auto-company concerned. The person buying the auto is not required to make arrangements for his own insurance coverage as these firms realise what a difficult task it would prove to be.*

Because of the largely ad hoc[59] and unsystematic approach that has been employed to compile certain sections of the balance of payments (b.o.p.), it was not possible to obtain a quantitative indication of any of the major insurance items we listed[60] earlier. The data that has been used for b.o.p. purposes in recent years appear in Table 3.27, where it can be seen that the net outflow has been steadily increasing. Between 1970 and 1977 it increased by more than four times, moving from $1.4 million to $6.0 million — an increase of over 300 per cent. The total net outflow in the eight years, between 1970 and 1977, amounted to more than $26 million.

Rough as these figures may be, and ignorant as we are of the transactions involved, the trend we have described above is clearly one that should be watched closely by the authorities. The lack of scrutiny which has characterised the approach of the latter in respect of expenditure claims and remission of funds by domestic insurers have been influenced to a large extent by two factors: (a) absence of a corporation tax; (b) the relatively high level of foreign exchange reserve which the country has been carrying for some time. While it would not be appropriate to discuss either of these factors at this juncture, the point should be made that there is no reason, because a resource may appear bounteous, why it should be squandered

TABLE 3.27

NET OUTFLOW OF NON-MERCHANDISE INSURANCE, 1970–1977

$m.

Year	(1) Inflow	(2) Outflow	(3) (1) – (2)
1970	2.6	4.0	–1.4
1971	2.5	4.9	–2.4
1972	2.4	5.1	–2.7
1973	3.1	6.5	–3.4
1974	–	2.5	–2.5
1975	–	3.6	–3.6
1976	–	4.1	–4.1
1977[a]	–	6.0	–6.0[a]

a: Provisional.

Source: Central Bank of the Bahamas, *Quarterly Review,* various issues.

without regard to the possible consequences for the country's long term development.

At a time when the community is in pressing need of capital resources, national responsibility would seem to dictate a closer examination of the instruments used for the remission of funds abroad. One such device is the agreement which some domestic firms have with their parent companies for the rendition of certain services e.g. actuarial, accounting, management, investment underwriting and so forth. While there are some legitimate foreign expenses that a domestic insurer has to incur, every effort should be made to see that: (a) the service is really needed; (b) that if needed, it is not available locally, and (c) if it has to be obtained from abroad it matches the payment claimed for it.

As it stands at the moment, it is quite possible for an insurer, unable to remit funds abroad as premiums or investments for lack of foreign exchange approval, simply to change to a designation (e.g. management fees) which the authorities may find difficult to refuse. This, it should be pointed out, can be done without a formal agreement with a company abroad. In one particular case, during the early '70s, a company based in the Bahamas and having operations in the Caribbean area was being bled to death through the management fee device by its American owners. In addition to deducting 40 to 45 per cent of total premium (which amounted to less than $200,000), for local management expenses, the owners were requiring 27 per cent (later reduced to 19 per cent) for home office expenses.

The injustice and dishonesty manifested in this siphoning process become all the more apparent when one looks at some of the agreements that two of the largest insurers operating in the Bahamas have recently concluded with their local subsidiaries. The first one with an annual premium income of more than five times that of the above company pays between 10 to 14 per cent of its premium income to its parent for a range of services including home office administration, accounting and actuarial. The second firm which is several times larger than the previous one (in terms of the amount of premiums collected) is liable to a similar percentage charge for an even wider range of services. As a reinsurance commission, the local subsidiary pays to the parent a yearly sum amounting to 5 per cent of the total annual premiums in force for a period of 15 years. Under a separate contract, the parent receives, on a quarterly basis, 10 per cent of the gross premium received in each quarter for the rendition of actuarial, investment, accounting, underwriting and a number of other specified services.

Some Final Observations

In the developing areas of the world, the financial sector, which up to now has operated within very narrow perspectives, is being called upon to play a more positive role in the national development effort. In the area of insurance, as in other related fields, there has been a variety of approaches ranging from regulations governing the disposition of assets to modification of the market structure. While a large number of countries have been content to lay down guidelines for the investment of technical reserves, a few others have sought to 'indigenise'[61] the industry either partially (e.g. Ghana and India)[62] or completely (e.g. Venezuela, Guatemala and Iraq). Some others have proceeded to nationalise[63] it in its entirety, (e.g. Ceylon, Costa Rica, Egypt, the Khmer Republic, the Syrian Arab Republic).[64]

In his study,[65] Odle drew attention to the unusually large number of insurance companies (mostly foreign owned) operating in the Commonwealth Caribbean area and underlined the need for rationalisation of the industry. As we pointed out earlier, the situation in the Bahamas is similar, and there is certainly no valid reason for its perpetuation. To argue, as some often do, that no harm is being done by the presence of such a large number of operators, and that, if anything, they contribute to government revenue,[66] is to miss the fundamental problem of the misuse and under-utilisation of scarce resources implicit in the existing market structure. In this connection, the simple point that has to be grasped, is that the present volume of business can quite possibly be carried by a smaller number of insurers at, perhaps, greatly reduced production and administrative costs (economies of scale), while at the same time freeing resources for other purposes. It has to be recognised that the present duplication of facilities and the unnecessary agency fees, management charges etc., that this entails is a social waste that the country cannot afford at this stage of its development. The problem of supervision, too, would be greatly simplified with fewer, but more solvent and viable companies.

Concluding Observations

Although the myth that banking services can only be rendered by foreign enterprises has only recently began crumbling in the Caribbean, in the field of insurance, local entrepreneurs have for long demonstrated an ability to successfully engage in this type of activity. Yet for various reasons, domestic markets, as we have pointed out, remain overwhelmingly under foreign domination. In view of the pivotal role which finance plays in the process of economic development, and given the need for mobilising domestic resources to the fullest in the national interest, the time has surely come for a closer look at the insurance industry in all its various aspects. Included here should be the services rendered in relation to the costs involved, both from the individual and community point of view, and the reasons for the perpetuation of the existing 'undesirable' national market structures.

It is true that, in an effort to alter the operating system inherited from the colonial days, various measures have been passed in some countries requiring greater domestic commitment of locally generated funds, and these certainly represent moves in the right direction. However, they have not gone far enough since they fail to deal with the devices by which funds are exported abroad or the efficiency of the industry and the consequent waste of resources discussed earlier.

Another area which needs to be investigated is the foreign exchange costs involved in the existing reinsurance arrangements. As pointed out earlier, this is a problem closely related to the present market structures with the numerous small enterprises that characterise it. One means open to a small operator wanting to underwrite a large risk is the reinsurance practice by which he cedes part of the risk to another insurer under a mutually agreed financial arrangement. Where the reinsurer is domiciled outside the country of the direct underwriter,[67] payments abroad for this service obviously mean an added burden on the foreign exchange reserves of the country.

There are some circumstances where reinsurance is unavoidable, e.g. where the national insurance market is very narrow or where the risk is too large to be absorbed at the national level. In many instances, however, the adoption of a rational approach to the industry can dispense with the need for a great deal of the reinsurance currently undertaken. With this objective in mind, a recent UN study[68] has drawn attention to the several advantages which many developing countries (and the insurers operating in them) can derive from institution of the pooling system in the direct underwriting business. Pooling is described as "a means of gathering risks on a broader level than that of the individual members of the pool and re-distributing these risks among them, thus levelling liabilities and premiums. To achieve that objective, an agreement by insurers and/or reinsurers is entered into whereby the whole or part of their underwriting in a given class is put in common".[69] "Normally, a specific class of insurance or a particular type of risk is dealt with by the pool. Every insurance policy written by the member companies in this class or type is then brought into the pool either for the whole amount insured or for a fraction of it. In the latter case, the member is free to retain or reinsure the remaining portion of the business.[70]"

To the extent that reinsurance from abroad is necessary, this could be obtained through a national reinsurance institution rather than through the effort of individual companies. This centralised approach to reinsurance may not only result in better utilisation of the national market, but may eventually lead to the acquisition of skills and bargaining power capable of obtaining more favourable terms for external cover and thus lower foreign exchange costs. National reinsurance organisations can also serve as centres for information gathering, which can contribute to the more efficient functioning of the national market. As an investment body, these institutions can encourage the establishment and growth of national insurance companies by contributing capital and technical skills which tend to be in short supply in developing situations.[71]

While national reinsurance institutions may be feasible in some countries with broad insurance markets, the industry may be too small in other to make these organisations an economic proposition.[72] In such a case it might be more fruitful to adopt a regional approach using the same pooling principle discussed earlier.

> *The structure of the markets within the region or sub-region does not affect the functioning of this kind of pool. Although the main objective of a regional or sub-regional pool is to share business among its members, it could be a first step towards a closer collaboration between the insurance markets of the area.*
>
> *It is obvious that by re-distributing reinsurance business a pool helps the countries of the region to retain more business for their own account. This observation is equally applicable to the individual countries and to the region, as a whole. Consequently, the foreign exchange outflow resulting from foreign reinsurance is*

reduced, at both the national and regional levels. The establishment of a pool at a regional level could also have other objectives: to establish a market with a high underwriting capacity within the region, to improve reinsurance terms for national companies; to promote loss prevention and to further cooperation among insurance and reinsurance companies of the region. A pool could also be a means of developing a regional investment policy. Lastly, exchange of business through a pool among several countries could lead to the establishment of an appropriate regional reinsurance institution.[73]

In the Bahamas there are several areas where action can immediately be taken with a view to improving benefits to the country from insurance operations carried on within its shores.[74]

(1) The prevailing element of uncertainty surrounding the export of insurance funds abroad should immediately be removed by instituting legislation to the effect of keeping all technical reserves in the country.[75] Such a move will not only help to protect policy holders, but would also assist in the development of the nation.

(2) At the same time a prescribed list of local assets for insurance companies should be drawn up with the relevant maximum or minimum of each type that can be held. By so doing, Government can obtain for itself an important allocative instrument which might prove to be extremely useful within the broader objectives of economic policy. It should be pointed out, too, that the present forms being used by the companies to submit information to the Government need to be re-drafted with a view to providing greater details which could be more useful to economic analysis and policy making.

(3) In view of the need to look more closely into the services offered and benefits accruing to the community in relation to the costs involved, an effort should be made to improve the staff of the Registrar's Office, which at the moment is not even equipped to deal with the simple tasks expected of it in the context of the existing legislation. To see that the companies comply with the statutory requirements and to examine the sales packages, tariffs, etc. of insurers and to make sure the public is fairly treated, the personnel aspect of the Registrar's Office needs to receive urgent attention.

(4) Steps should immediately be taken to bring about an improvement in the operations of the locally owned companies. This can be done to some extent by urging an amalgamation of some of the smaller uneconomic operators which at the moment lack the expertise and organisation for survival in the existing environ-

ment. As pointed out earlier, it was possible for one locally owned company to organise its affairs in a way that made it one of the strongest competitors in the domestic market. Surely, in view of the ability of this one operator to attain this high level of efficiency it is possible for other local entrepreneurs to emulate this example and perform equally well.

With the emergence of viable Bahamian enterprises, Government can then begin to reserve certain types of risks (public and private) for these companies which eventually should be controlling a significant part of the domestic market. There is absolutely no reason why the insurance sector should not come under local domination.

Some might view this position as being in conflict with the country's free enterprise image and open-door policy. However, since the insurance industry deals largely in funds generated domestically (there is very little of the companies' capital involved), the development of the local community has prior claim to these resources; and any structure which would ensure this objective does not, in any way, violate the country's open-door policy or tax-haven image, though there are some who tend to confuse local funds with external capital, largely because the former has been mobilised under the umbrella of a foreign enterprise.

'Captive Insurance Companies'

In the discussion on domestic insurance operations, allusion was made to the fact that there were a number of 'offshore' companies which were registered in the Bahamas, but which did no local business. The total number of such companies at the end of 1978 was estimated to be around sixteen.

The companies referred to as 'offshore' operators fall broadly into three groups. The first category, which at the end of 1977 comprised only two insurers, appears to be essentially a tax saving device intimately related to the administration of a private estate which has been entrusted to a non-resident bank in its capacity as trustee. In both cases, the owner was the trustee and the business of the companies for all intents and purposes seemed to be confined to insuring lives and property falling within the ambit of the trust arrangements and the investment of funds derived from their operations. The second group (which comprised only about five companies)[76] use, or hoped to use, the Bahamas as a base from which to conduct an 'offshore' reinsurance business. The third category was made up of entities known in the insurance world as 'captive' insurance companies. At the end of 1978, there were nine such insurers registered in the Bahamas. In view of government's recent amendment to the Insurance Act of 1969 to encourage the registration of 'captive' insurance companies (in the conviction that this action will have a favourable impact on the economic development of the Bahamas), we hope, in the discussion that follows, to define what 'captive' insurance companies are, outline the conditions that have given rise to their emergence and put in perspective some of the benefits and problems associated with their presence in offshore centres. A subsidiary reason for undertaking this somewhat detailed exercise is related to a perceived need to provide an insight into a little known aspect of the activities of multinational corporations, viz., self-insuring through an insurance subsidiary located in a tax haven.

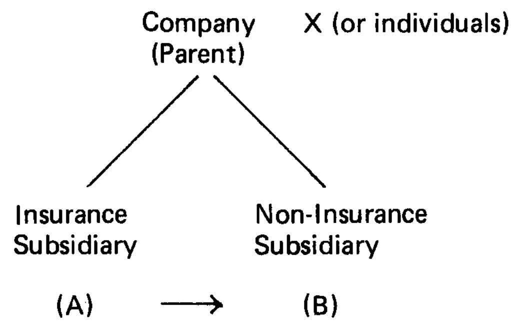
A 'Captive' Insurer Definition

There are various definitions as to what really constitutes a 'captive' insurance company (sometimes also called a controlled subsidiary, a committed subsidiary, or a wholly owned subsidiary). One of the most commonly accepted, however, is that of Frederick Reiss, who defines a 'captive' insurer as a "wholly owned Insurance Subsidiary with a primary function of insuring the outstanding exposures and risks of the Parent Organisation".[77] Even with this definition, there are a number of inadequacies which Robert Goshay has discussed in a brilliant article published in 1964.[78] While Reiss' definition is

> *adequate in the sense that it conveys the concept of ownership, (implicit) control, and ad hoc use of an insurance carrier for specific purposes,* [he contends, it *is too broad*] *since it includes many insurers not logically 'captives' and excludes controlled, but not owned insurers and some insurers not wholly owned, but nevertheless, used in a captive relationship. For example, insurance carriers owned by finance companies would be classified as 'captives' according to this (Reiss') definition, since many of these carriers insure exposure 'owned' under conditional sales contracts issued by financial institutions. Actually, such insurers are classified as 'captives' only in the sense of their being special-purpose carriers. They actively compete in many cases with other non-finance-controlled insurers for the business of the general public.*[79]

Essentially, what Goshay is saying is that since the subsidiary probably has to compete for the business of the latter with other insurers, it does not have a 'captive' insured,[80] and therefore cannot be described as a true 'captive', even though it does qualify in some senses. There are two other weaknesses which Goshay sees in the definition and which are worth mentioning. The first is that it "does not encompass as a captive, the insurance carrier owned and controlled by individuals owning another enterprise'.[81] The point is illustrated in Figure 3.1 which shows an insurance subsidiary insuring the risks of a non-insurance subsidiary of the same parentage. In other words, it seems to me that all he is saying is that the last part of Reiss' definition should be extended to read " . . . outstanding exposures and risks of the Parent Organisation or Owners and their **affiliates**". The final observation he makes is that the definition "ignores the fact that an insurer can be in a captive position — both with respect to ownership by Parent and risks insured there as well as with respect to ad hoc use – and still not be wholly owned". Partial ownership, he argues, can constitute a controlling interest and by the same token can constitute a captive relationship.

Figure 3.1: Relationship Problems in the 'Captive' Definition



Having looked at some of the main relationships that define a 'captive', we briefly turn our attention to a discussion of the four categories into which these institutions are normally divided.

(i) The Pure (or Limited) Captive

This is a wholly owned subsidiary formed to insure and/or reinsure the risks of the parent corporation and those of its branches and affiliates. A prominent example of a pure captive is the Gulfstream Insurance (Bahamas) Limited, which is owned by Distillers Corporation-Seagrams Limited, and which was formed to insure and reinsure the exposures and risks of the Distillers Corporation-Seagrams Group reputed to be the world's largest distilling organisation.

(ii) The Association Captive

This is an insurance company formed by a number of corporations in the same business or industry, with the purpose of insuring risks peculiar to that industry. Their formation in most cases is induced by the unavailability of coverage in the regular markets or where the price is too high when insurance is purchased on an individual basis. An added incentive is the financial strength resulting from the pooling of risks and money. Examples include the Bermuda-based Tanker Owners' Pollution Mutual, International Tanker Indemnity Association Limited and the Mutual Insurance Company Limited, formed by U.S. Newspapers to provide strike insurance and also located in Bermuda.

(iii) The Senior (or Broad) Captive

Unlike the pure captive whose underwriting is confined to the risks of the parent and affiliates, the business of the senior captive extends outside these limits, e.g. Pental Company Limited.

(iv) The Profit Centre Captive

In this type of operation, underwriting the risks of the parent corporation is incidental to its overall business. In some quarters, it is argued that this kind of insurance company is not strictly a captive and, therefore, should not be classified as such. Commenting on Sears Roebuck's wholly owned subsidiary, Allstate Insurance which is often cited as an example of a 'profit centre' captive, Sherar remarks that "Allstate is an entirely separate insurance company even though it is wholly owned by Sears. It was not organised to insure Sears' risk and, as a matter of fact, we believe that even at this time it only insures part of Sears' programme".[83]

The concept of the 'captive' insurance company is by no means a new one. At least two are known to have existed before 1900. For reasons that will be explained shortly, however, they have grown increasingly popular in recent years. The total number in the world increased from about 100 in 1966 to over 1,000 at the beginning of 1979. Of this latter number, 900 are believed to be domiciled in Bermuda.

Insurance and the 'Captive' Concept

A large company seeking insurance is faced with three possibilities: (i) it can go out in the open or commercial market; (ii) it can retain its risks within the framework of a self-insurance programme; and (iii) it can set up a 'captive' insurance company. Possibility (ii) is not, technically speaking, insurance since it involves no transfer of risks to outsiders. The third alternative is a hybrid of transfer and retention in the sense that while the company's risks are insured by a separate entity, the fact that this latter is owned wholly or partially by the company whose risks are involved, means the business remains within the structure of the enterprise. Hence, the reason why a 'captive' is sometimes referred to as a self-insurance programme committed to corporate form.

Before going on to discuss some of the reasons behind the recent proliferation of 'captive' companies and the advantage of this facility, it would be instructive to examine briefly the economics of the concept.

As will be seen later, while the insurance function is a central factor in 'captive' formation, the financial aspect is also an important consideration. In other words, corporations that resort to the setting up of these institutions as an insurance vehicle also hope to derive a profit from their operations — or at least to incur smaller insurance expenses than in their traditional programme. The critical question, then, facing the corporation is at what point in the growth of the company should it decide to set up its own insurance subsidiary, if it is to realise these twin objectives at the same time. While there is no single answer to this question, given the number of factors involved, one of the most important considerations is the volume of business expected to accrue to it. In this connection, premium levels ranging all the way between $100,000 and $1 million have been put forward from time to time. Some people like Mc Rell, ignore figures and advocate the view that a captive "should be created when the need exists, whether it be a financial need or the inability to obtain a specific type of coverage which the parent corporation requires in today's competitive market". [84] While these considerations, however, provide the necessary incentives for embarking on a captive programme, they do not dispense with the conditions necessary for financial viability or insurance competence by the enterprise, since there are not only costs involved in operating a captive, but more importantly, it has to be in a position to meet claims made upon it by the parent concern from time to time. Factors, therefore, such as spread of risks, frequency of losses and availability of reinsurance facilities are important considerations in deciding upon a self-insurance programme.

In fact, the last factor mentioned is essential to the economy of the captive which normally retains only a percentage of the total risks assumed, the rest being placed in the reinsurance market,[85] usually on an excess of loss basis.[86] The relationship between the parent corporation, the insurance subsidiary and the reinsurance facility is set out in Figure 3.2. While the greater part of the exposure of the captive's parent very often tends to be covered by reinsurers, there is no direct relationship between the two latter entities. In other words, while the 'captive' is an insurance company, it is more in the nature of an intermediary ('insurance conduit')[87] whose risk-retaining capacity itself tends to be, in most cases, very small, the greater part of the cover being borne by reinsurers for a price (reinsurance premiums). The amount actually retained by the subsidiary (the net retention) is dependent on such factors as capital and surplus structure[88] and the size and quality of the risks involved.

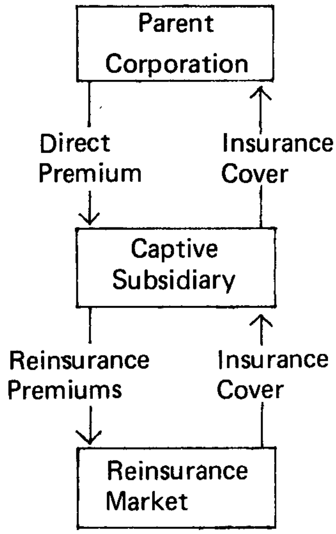
From the parent's point of view, there are two immediate advantages from these arrangements, which can be stated here. One is monetary in the sense that since the cost of reinsurance is normally cheaper than direct insurance purchase, there is a saving element involved. The second is even more important in that the captive by undertaking to bear a proportion of any losses incurred, is able to procure cover in the reinsurance market for risks which in some cases do not appeal to underwriters in the direct market. There are a number of others which will be discussed shortly.

Reasons Motivating the Growth of 'Captives'

The trend towards the formation of 'captives' has been influenced by a number of factors affecting the direct insurance market, particularly that part concerned with large or high hazard risks. One of the most important of these has been the growing unwillingness on the part of traditional underwriters, such as Lloyd's, to write large lines, in view of the poor underwriting results that characterised this area of business in the late '60s and early '70s. The resultant shrinkage in capacity has thus forced a

FIGURE 3.2

The 'Captive' Company and the Reinsurance Market



large number of corporations to explore and develop alternative insurance programmes to cope with the changing structure of the market. Not only has there occured a shortage in capacity in recent years, but for some classes it has been impossible to obtain cover in the commercial industry.

In this context, it has been discovered that the captive concept is not only capable of solving these problems, but also has a number of other advantages over conventional methods of insurance. These can be summarised as follows:

(i) *Cash Flow:* One of the biggest advantages to be derived from the formation of a captive is the reduction in cash flow from the corporate group. Premiums which normally are paid to a commercial insurer can be put to work for the benefit of the parent and its affiliated companies.

(ii) *Tax Benefits:* Under Section 162(a) of the U.S. Internal Revenue Code, a corporation is permitted to take a tax deduction for all genuine expenses paid or incurred in the conduct of its trade or business. This, of course, includes premiums paid to insurance companies, wherever they are located. In cases, however, where an enterprise decides to provide its own insurance by setting up a reserve fund within the organisation to cover losses that may be incurred in the future, sums paid into this fund are not tax deductible.[89] One of the objections advanced by the tax authorities is that such payments do not constitute a legitimate expense since the 'reserves' in which they are put remain within the control of the company and available for its use. In this context the 'captive' concept is an ideal device since not only is the premium paid to such an entity tax deductible for the parent corporation, but the money so expended remains within the control of the corporate structure. In cases where the 'captive' is located in a tax haven, there are additional fiscal benefits to be derived. These will be discussed later.

(iii) *Lower Premiums:* Premiums paid for insurance in the commercial markets are often loaded to take account of a variety of Head Office expenses. Included also are elements reflecting commission and brokerage charges and other selling costs.[90] An insurance subsidiary set up to insure only the risks of its parent can afford to offer its services at lower costs by not having to face some categories of expenditure just described. At a time when both premiums and deductibles are going up at the same time, costs are a critical consideration for a corporation deciding upon an insurance programme.

(iv) *Lack of Market:* As indicated earlier, it has been impossible to obtain coverage for certain types of risks in recent years at any price.[91] Some of the reasons for this situation can be attributed to lack of capacity, uncertainties in new areas of technology, or because of great losses that have been experienced in some recent man-made and natural disasters.[92]

(v) *Reinsurance may be more easily obtained:* "The captive insurer will give the group access to the reinsurance market, where it may find greater flexibility than amongst direct insurers, particularly where over a period of years it has been able to prove the quality of its inderwriting. This can be valuable in placing new types of risks which the market may view with suspicion, or risks for which market experience generally has been bad".[93]

(vi) *Greater attention paid to loss prevention:* Since the incurring of losses would tend to bite into the profits of the captive, there would be a natural tendency to pay greater attention to loss prevention and control, than would be the case in a commercial arrangement.

(vii) *Saving on brokerage commissions:* By having its own insurance company, a corporation is in a position to dispense with the expenses associated with brokers' (middlemen) services, thus adding further to the cash flow of the group.

(viii) *Greater self-assurance:* Under a pure self-insurance arrangement, the corporation decides how much of each loss it can retain and then contracts out the excess to commercial underwriters. Within the framework of a properly run captive, the parent company is not only able to overcome many of the deficiencies inherent in a self-funding programme, but can also afford to retain a great part of its risks normally covered by outside insurance.

(ix) *Broader Coverage:* One of the major criticisms directed against the insurance industry in recent years has been its unwillingness or slowness in evolving new concepts to meet the changing needs of the market. One area which has come in for critical appraisal is the inclination of the industry "to indulge in specialised underwriting which inhibits cooperation between segments to develop the total concepts necessary to accommodate an assured".[94] With the flexibility inherent in the captive structure, there is not only a greater opportunity of devising new forms of coverage to meet the peculiar needs of the parent and other members of the group, but at the same time the problem of dealing with several insurance companies is removed. In other words, under one form and subject to a single deductible, a corporation can arrange its entire insurance programme which may cover every aspect of its operations, for example, product liability, fire and machinery.

(x) *To facilitate the international movement of funds:* The establishment of an international 'captive' can serve as a useful vehicle "for moving insurance premiums between various countries of the world, as international insurance premiums flow with less currency restrictions than other forms of funds"[95]

(xi) *No restrictions on investment:* A 'captive' company located in a tax haven is not generally subjected to any local regulations as regards the investment of its reserves or surplus. With due account taken of its liability requirements, such a company can choose assets with the highest returns and thus accelerate the financial growth of the enterprise which also has the benefit of tax free profits [96] from its insurance operations. With these attributes, the 'captive' is ideally placed to act as a financing centre for the parent's worldwide operations in need of expansion or capitalisation. In this context, the captive is in a position to purchase facilities such as plants and tankers and lease them back to the parent.

(xii) If simplifies claim service and loss adjustments.

(xiii) *Activity Diversification:* A corporation wishing to diversify its interests can use the captive subsidiary as a means of entering the insurance business.

(xiv) A final major advantage associated with captives is the attainment of uniformity of coverage on an international basis.

Factors Affecting the Location of Captives

In terms of location, captives can be divided into two broad groups, viz., 'domestic' and 'offshore'. Since about 95 per cent of the captives in existence today are belived to be owned by U.S. corporations, our discussion on the choice of location will be conducted largely from an American perspective. In this context, a 'domestic' insurance subsidiary will be one formed within the limits of the continental United States, while an 'offshore' captive will refer to one incorporated in a country outside the U.S., usually in a tax haven. The present ratio of offshore captives to domestic captives is estimated to be in the region of 3 to 1. In the following section we discuss some of the major factors explaining this distribution. Firstly, however, we should dispel some popular misconceptions surrounding captives which have sprung up in recent years.

While many bogus captives have been set up over the years, giving rise to a great deal of suspicion about the real motives behind this type of institution, the primary purpose of forming a captive is to carry out the business of insurance even if it is within a very restricted framework. The captive represents first and foremost an insurance technique whose principal attraction lies in the lower insurance costs that it offers,[97] and this was, undoubtedly, the initial motivation in its conception. With the passage of time and with new developments taking place in the commercial insurance market, it was found that the technique offered a number of other advantages as well. For example, it was found by locating a captive in a tax free jurisdiction, a multinational company would be able to "develop the necessary interplay between their subsidiaries in various foreign areas, using each to its own best advantages, and thus maximising the economic gain of the entity"[98] Again, "large payments to a captive insurance company in a relatively stable country financially as, for example, Bermuda has enabled monies to be removed lawfully from countries like Brazil and other countries during periods when they suffered seriously from inflation".[99] One of the main advantages of locating a captive in a tax haven, however, is the tax benefits which it offers to the parent company – and it is with respect to this aspect of captive that the following section is taken up.

From what we have just said above, it is clear that Donaldson's contention that the "concept of the 'captive offshore' insurance company is essentially one relating to United States Internal Revenue Code",[100] is not altogether correct, even though there is a substantial measure of truth in it. This is further seen in the fact that despite the intention expressed by the U.S. House Ways and Means Committee a few years ago to remove one of the major Federal Income tax advantages enjoyed by offshore captives,[101] the formation of these companies in certain centres outside the U.S. has gone on unabated. Commenting on the move, one tax lawyer, an expert on captive matters, remarked: "I know of really few companies that were set up solely for tax motives. The big sweetner is still in control of the cash flow".[102] We've not set up two captives for the same set of reasons", observed another leading manager in the captive field. "Tax considerations are of varying importance"[103] Still, as pointed out earlier, the tax advantage is an important consideration in the setting up of many captives and the attitude of the U.S. revenue authorities certainly has an effect on the operations of these institutions.

The existing tax rules governing the income of 'captive' companies have their basis in the Revenue Act of 1962 – in particular sub-part F of the Internal Revenue Code which was enacted as part of that legislation. Before the coming into being of this Act whose major aim was to discourage tax deferral earnings, it was possible for a captive to accumulate premium income from the insurance of both U.S. and foreign risks without being subject to U.S. tax. A major effect of the 1962 legislation, however, was to make the income of captives conform to certain specified criteria subject to U.S. taxation, even when no distribution took place.

In the context of the Inland Revenue Service (IRS) Code, there are two major factors which determine whether the income of a foreign captive is subject to U.S. taxation or not. One is the question of control, while the other relates to the geographical location of the risks being insured. Control is established if more than 50 per cent of the voting power of all classes of stock is owned by U.S. shareholders.[104] A foreign corporation is also deemed to be U.S. controlled with only 25 per cent of the voting stock held by United States shareholders, if 75 per cent of its premium income is derived from the insurance or reinsurance of U.S. risks. It should be pointed out, however, in the former case, even when control is established, the income of a foreign corporation does not become automatically liable to taxation. If 95 per cent or more of its premium income is derived from the insurance or reinsurance of foreign risks (i.e. risks outside the U.S.), there is no liability by the shareholders to taxation in the current year. In other words, the foreign captive can insure and reinsure U.S. lines or property to an extent amounting up to 5 per cent of total premium income without incurring tax liability on current income in that country. In all cases, however, tax is payable by the U.S. shareholder when dividends are declared or profits repatriated.

Another area of concern for the foreign insurance company is the manner in whch investment income (dividends, interest, capital gains) is treated in the IRS Code. Under the current regulations all such income is taxable, except in special cases, for example, where they are derived from "those unearned premiums and reserves" (so invested) which are deemed "ordinary and necessary" for the proper conduct of the foreign company's insurance business.[105]

As an addendum to this section, it should be stated that the U.S. Internal Revenue Service in January of 1972 drew up a new set of guidelines[106] in which it refused to recognise the payment of premiums[107] to a foreign captive as a legitimate business expense. Rationalisation of this stand was based principally on two arguments: (i) the captive is a sham corporation that was created for the principal purpose of evading or avoiding U.S. taxes; and (ii) the premium rates and other charges and fees between the related companies are not realistic in amount, meaning that the parent's tax liability in the U.S. is being artifically reduced.[108] A similar ruling was again made in August 1977.

Since then, a virtual state of tension has existed between the IRS and the corporations owning captive insurance companies. In two recent test cases (one involving the Ford Motor Co. and the other the Carnation Co.) brought before the U.S. Tax Court, one (the Ford case) was eventually settled by an out-of-court settlement of compromise (favourably to Ford), while in the Carnation case the judge ruled that premiums paid by this corporation to its Bermuda captive did not constitute insurance, and therefore could not qualify for tax deduction. Though the decision seemed to have been based mainly on the conclusion that arrangements with a third company cancelled out any risk shifting to the insurance subsidiary, the ruling provided cause for concern in the entire captive industry.

The formation of captives is reported to have slowed down noticeably in the period immediately following. Observers, however, are of the view that bona fide[109] captives will not be affected, particularly those operating on the basis of profit centres, mutuals or group-owned arrangements. It is argued, as indicated earlier, that in the modern day insurance world tax benefits are not the most important reason behind the formation of captives. The fact remains, however, that in the light of the unclear and equivocal position taken by the IRS, the offshore captive industry functions in an atmosphere of uncertainty at least with respect to the tax advantages associated with the formation of insurance subsidiaries.

From what has been said above, it is clear that it makes little sense to incorporate a foreign captive to insure or reinsure U.S. risks. Most of the insurance subsidiaries that have been set up in 'offshore' centres since 1962 are in fact mainly intended to cover the international risks of big United States multinational corporations who have enough foreign assets to make a captive a viable and worthwhile enterprise. For reasons that would become clear later, however, there are several foreign captives which are engaged in writing U.S. risks in varying degrees, notwithstanding the existence of taxes[110] on premiums paid to overseas located insurers. In the following section, note is taken of some of the main operational and financial requirements governing the formation of insurance subsidiaries within the United States, particularly those obtaining in the State of Colorado, and then proceed to compare them with the tax-haven framework of the Bahamas and Bermuda.

Before the enactment of the Colorado Captive Insurance Company Act of 1972, there was no specific legislation within the United States governing the operations of captive companies which tended to function within the general insurance regulations of each state. In these legislations, while capital and surplus requirements vary from state to state, they are generally very high. In New York, for example, the figure is in excess of U.S. $3 million. In addition, there are everywhere in the Union countless administrative controls to comply with, not to mention the stringent regulations governing the investment of funds for which state governments are noted, and the premium taxes and the obligation to support plans and funds of various kinds.

For corporations interested primarily in insuring domestic risks, therefore, the passing of the Colorado legislation[111] which recognised the special character of the captive facility was of great interest. The Act, it should be pointed out, is designed to meet an insurance need rather than to encourage the setting up of tax saving entities. This intent is readily apparent from the outline of its main provision which follows:

(1) Section 72–36–5(2)(a) of the Act states that before a certificate of authority to engage in insurance business in Colorado is granted, the applying company "must demonstrate to the satisfaction of the commissioner that adequate insurance markets in the United States are not available to cover the risks, hazards and liabilities of the parent and companies to be insured, or that such needed coverage is only available at excessive rates, or with unreasonable deductibles and that the total insurance coverage necessary to insure all risks, hazards, and liabilities of the parent and companies to be insured would develop in the aggregate, gross annual premiums of at least $500,000."[112]

(2) Minimum capital and surplus requirements are laid down at $400,000 and $350,000 respectively. This can be satisfied with an irrevocable letter of credit.

(3) Premium taxes on captives have been set at 1 per cent of 'net' premiums. In addition, there are no state income taxes or Federal excise taxes assessed upon premiums paid to captive insurance companies. Federal income taxes, however, are payable on annual profits.

(4) Rates made by a captive are subject to review by the commissioner of insurance who has to be satisified that they are not excessive, inadequate or unfairly discriminatory.

(5) Captives are also exempt from participating financially in any plan, pool, association or guaranty or insolvency fund in the State of Colorado.

(6) Like other insurance companies, captives licensed in Colorado are subject to restrictions on investment, annual reporting, financial examination and approval of policy forms.

Bermuda

As indicated earlier, Bermuda is the world's largest centre for offshore captive insurance companies, accommodating over 90 per cent of such entities in existence. There are, at the moment, more than 1,000 'exempted' companies [113] of which 900 are believed to be captives. Not all of these are active. While a large number of these are engaged in underwriting only the business of their parents, others cover unrelated risks. The gross premiums collected by the captive industry in Bermuda is estimated to range between US$1 billion and $5 billion. Capital and surplus amount to about $2.5 billion, of which two oil companies account for 20 per cent. In terms of foreign currency bank deposits held by all 'exempted' companies, the figure was put at about US$3 billion at the end of 1977.

These data give some idea of the proportions the industry has assumed in recent years and it is instructive to speculate on the factors which have contributed to this growth. Until the Insurance Act of 1978 (which became effective from 1 July, 1979), there were no stringent regulations governing the operations of offshore insurance companies. All applications went through a screening process intended to separate the genuine insurers from the fraudulent operators. Once a Corporate Charter was granted there were no restrictions governing the investment of reserves or premium incomes. The minimum paid-up capital was relatively small ($120,000) and there were no stipulations with respect to the relationship between capital and surplus and the volume of business underwritten. A large proportion of the companies registered, in fact, operated on the basis of the minimum required capital.

Another important factor contributing to the popularity of Bermuda stems from the fact that the country not only does not have a corporation tax, but the government gives exempted companies a guarantee against income taxes until 2006 in the event that such measures are introduced. Other factors include a close proximity to the east coast of the United States, financial stability and the operation of a liberal exchange control regime[114] which provides for the easy movement of funds between Bermuda and the United States where the majority of the parent companies are located. The availability of sophisticated investment and banking services plus the growing reinsurance capacity have also added to Bermuda's popularity.

A final reason which has helped in establishing Bermuda as the world's leading centre for offshore captives, stems from the fact that there has never been any scandal or failure involving insurance companies of the kind that hit the Bahamas in the late '60s, and which, undoubtedly, contributed to the decline in popularity of this latter country. Up to that time, the Bahamas was a much more important centre for offshore insurance companies than Bermuda.

The Insurance Act of 1978 culminates a long period of concern about the need for greater supervision and surveillance over Bermuda's mushrooming insurance industry. Before this legislation, the Minister of Finance had the power to intervene in the affairs of a company experiencing financial difficulties, but in the absence of adequate data it was not always easy to detect such companies in time. The new Bermuda Insurance Act of 1978 which came into effect from 1 July, 1979, (but from which companies can seek an exemption until 1 July, 1980), not only requires companies to provide a wide range of data with respect to their underwriting activities (such as the degree of unrelated risks being underwritten, the company's retention, the extent of reinsurance, a list of reinsurers etc), but also seeks to set up a relationship between capital and surplus and the volume of business underwritten. The proposed underwriting ratio is 3 to 1. In order to control lending of capital and surplus to affiliated companies, the new law does not permit the inclusion of such funds in admitted assets which must equal 75 per cent of the company's insurance liabilities. The solvency of the companies appears to be the main focus of the new legislation.

'Captives' in the Bahamas

As pointed out in an earlier section, there were over 300 insurance companies registered in the Bahamas before the Insurance Act of 1969, which introduced more stringent requirements for companies wishing to retain their registration in this country. The initial impact of this piece of legislation was to scare away more than 200 of these companies which consisted principally of the 'suitcase' or 'bandit' type operators discussed earlier, and to a lesser extent, the 'quick buck'[115] captives which were essentially set up as tax-saving devices for the parent company. Also included were a number of genuine captives who saw the legislation as a prelude to the introduction of nationalistic measures such as income taxation.[116]

In an earlier section, we discussed the general implications of the 1969 Insurance Act. At this point, however, it might be appropriate to recall some of its major provisions, particularly those sections affecting captive companies which were treated in the same way as all other operations. In other words, the Act made no distinction between companies operating locally and those engaged exclusively in offshore business.[117]

Firstly, the Act calls for the registration with the Government of all companies operating in or from within the Bahamas. For the privilege of using this haven as a base for foreign operations or for local underwriting, a charge is made upon each company. This takes the form of an initial registration payment for a new entrant and a subsequent minimum fee at the beginning of each year. Both charges vary with the type of insurance written and the volume of business. In no year, however, shall the total fees payable by any insurer exceed $5000.00 or be less than $500.00.

The second significant feature of the 1969 Act was the stipulation of minimum capital requirements for companies operating both in and from within the Bahamas. In the case of a life company the sum required was

$300,000. For a non-life insurer (in which category "offshore" companies largely fall) on the other hand, a relationship between assets and liabilities was specified.

> *Any registered insurer doing insurance business, other than life assurance business, shall have assets that exceed all liabilities by the amount of one hundred and forty thousand dollars in the case of an insurer who was not doing insurance business at the date of the commencement of this Act, or in the case of any other insurer by the amount specified in the following table:*[118]

Case	**Amount**
1. The non-life assurance premium income of the registered insurer in its last preceding financial year did not exceed $700,000.	*$140,000*
2. The said income in that year exceeded $700,000 but did not exceed $7,000,000.	*One fifth of the said income in that year.*
3. The said income in that year exceeded $7,000,00.	*The aggregate of $1,400,00 and one-tenth of the amount by which the said income in that year exceeded $7,000,000.*

A third important provision of the Act to which attention has already been drawn, relates to the investments of insurance companies. Section 2 of Article 9 of the legislation states that the "Minister may require that a registered local insurer shall not make investments of a specified class and may in that case require such insurer to realise investments of that class within a specified period". The fact that a 'local insurer' is defined in the Act as "an insurer incorporated or constituted in and having its head office in the Bahamas" means, as already indicated, that both domestic and captive insurers are affected to the same degree by this provision, even though it would seem that the inclusion of this section was aimed principally at the local insurer writing domestic business.

A fourth requirement of the Bahamas Insurance Act to which offshore insurers everywhere are particularly sensitive is the publication of financial statements. The parent company, in most cases, prefers all transactions between itself and its subsidiary to remain under confidential cover for reasons that are all too obvious. And this traditonally has been the case. For while a great deal has been written about the advantages and disadvantages of the formation of captives, little is known about the financial operations of these enterprises.

As indicated earlier, while the enactment of the foregoing requirements resulted in a great stampede from the Bahamas, a number of 'offshore' companies (about 20) stood their ground. These can be divided into two groups. Firstly, there are the few that are being used purely as tax-saving devices. In other words, they are not performing an underwriting function, though they have been set up behind an insurance facade. Secondly, there are the 'true' insurers engaged in insuring and reinsuring a wide variety of risks which are too expensive to be insured in the conventional market or for which capacity is not available. Included in the latter group, are a number of shipping companies which have set up mutual operations to cover the losses of their members.

The Amendment to the 1969 Insurance Act

In 1978, the Bahamas government amended the 1969 Insurance Act, with the aim of attracting 'offshore' insurance companies which it obviously feels can make a contribution to the local economy. The word 'captive' does not appear in the amendment. The broader term 'non-resident insurer' is used and this is defined as a "registered insurer who issues a policy covering underlying or primary risks on property, lives or any other risk located outside the Bahamas". The main thrust of the amendment is to exempt non-resident insurers from the payment of the one per cent gross premium tax (which was instituted in December, 1975), and from the publication of their balance sheet and accounts. They are required, however, to submit copies of their audited financial statements to the Registrar of Insurance.

Conclusion

It is still too early to assess the effects of these legislative changes on the attractiveness of the Bahamas as a centre for offshore insurance companies. Certainly there has been no immediate rush to set up insurance subsidiaries in this tax haven. The Bahamas infrastructural facilities compare well (in fact in some respects they are superior) with those of the Cayman Islands (which at the moment has 50 captives) and Bermuda, the home of the world's largest number of offshore insurance companies. Assuming that there were to be a step up in captive activity, the really fundamental question that has to be asked is, can the presence of these entities in the 1980s exert a significant effect on domestic economic life? Their impact during the 1960s was dubious to say the least.

The business of captives is looked after by management companies which can be organised to conduct the affairs of a large number of them. The presence of these institutions will create a certain number of jobs, as will the activities of the reinsurance and accounting firms that may be attracted. To the extent that funds are kept in local institutions, the banking business will be boosted. Some revenue will be derived from the payment of fees to government. As far as the investment of funds are concerned there is no fixed pattern that one could discern. Certainly, local developmental objectives are not their concern and as 'non-resident' companies (for exchange control purposes) they are authorised to dispose of their funds as they see fit, and what they see fit is dictated by the international operations and aims of the parent company whose needs these insurance subsidiaries are created to serve. A major purpose for the establishment of captives in tax havens is the lack of restrictions over the investment of insurance funds, and though the Minister of Finance has some power in this area (as indicated earlier) this is not likely to be exercised on the offshore insurers except to the extent that concern with solvency may dictate. It is significant that this part of the Insurance Act was retained as a general regulation applying to all insurers. The Bermuda experience offers some useful lessons in this regard.

Against the above benefits one has to weigh the problems of supervision which is crucial to the prevention of unscrupulous operators using the Bahamas as a base from which to conduct illicit activities. Supervision has to be seen as a continuous process, and this obviously calls for an organised and trained department operating within a framework of explicit criteria and objectives. In the absence of this, repetition of the difficulties which smeared the Bahamas during the 1960s could well recur.

FOOTNOTES

1. The unusually large number of insurers (particularly non-life operators) registered in the Commonwealth Caribbean has been cited by Odle as one of the salient characteristics of the industry in the area. See M.A. Odle, *The Signifiance of Non-Bank Financial Intermediaries in the Caribbean,* Institute of Social and Economic Research, U.W.I., 1972, p.30.
2. See *Sigma,* No. 10/Oct., 1972.
3. See Odle, *op. cit.* p.32.
4. Other factors that may affect the volume of business contracted can stem from the intensity of the marketing effort in terms of sales force, advertising etc.
5. Using the data in Table 3.6 and the product moment formula, the correlation coefficient works out to around 0.95.
6. Figures published by the Department of Statistics show that in 1970 the lowest 60 per cent of households received 26.9 per cent of total disposable income while the top 40 per cent received 73.1 per cent. (See chapter on the Bahamian economy).
7. The most common intervals are one year, five years, ten years and twenty years.
8. S.J Lengyel, *Insurance Companies' Accounts, An Economic Interpretation and Anaylsis* (Melbourne, 1946), p. 1.
9. *Ibid.,* p. 2.
10. This part of the Act reads as follows: A registered insurer shall, within six months of the end of each financial year, prepare and furnish to the Registrar –
    (a) a certified copy of the audited balance sheet and accounts showing the financial position of all the insurance business of the insurer at the close of that year; and

    (b) such other documents and information as the Registrar may require or as may be prescribed by regulations and shall at the time of furnishing the balance sheet and accounts to the Registrar as required by paragraph (a) of this sub-section cause a summary thereof in a form previously approved by the Registrar to be published in the Gazette.
11. The investment income reported are earnings accruing from local assets. Insurance companies also hold foreign investment against local liabilities. The extent to which income from their external portfolio is repatriated is not known.
12. Another distinction that is sometimes made in the context of calculating loss ratios and underwriting profit is that between earned and unearned premiums:

    Earned Premiums of the Year = Premiums received **plus** unearned premiums brought forward from the previous year, **minus** unearned premiums carried forward to the next year.
13. A.H. Mowbray et al., *Insurance, Its Theory and Practice in the United States,* Sixth Edition, New York, McGraw Hill Book Company, 1969, p. 436.
14. *Ibid.*
15. H.A.L. Cockerell, *Insurance* London, The English University Press, 1970, p. 39.
16. Opinions vary widely on this score. In terms of underwriting profit to premium income a rate of return of 5 per cent is often used. If investment income is included, a return ranging from 5 to 12 per cent is considered adequate.
17. Of the $25.7 m collected in premiums by this group in 1977, $8 m or 31 per cent were derived from non-life business.
18. An example of such as item would be management expense.
19. See George Clayton and W.T. Osborne, *Insurance Company Investment: Principles and Policies,* London, Allen and Unwin, 1965, p. 26.

20. These expense figures do not include payments for corporation taxes which are not imposed in the Bahamas. Since 1976, however, insurance companies are required to contribute 1 per cent of their gross premiums (on a quarterly basis) to government revenue.

21. See R.L. Williams, "The Cost of Mobilising Savings in Jamaica by Life Insurance Companies: A Comment". Paper delivered at Seminar on Life Insurance in Jamaica, sponsored by the Jamaica Chapter, Society of International Development, Kingston, May 1973.
See also Asgar Ally's Paper, "The Role of the Life Insurance Dollar in the Jamaican Economy" delivered at the same conference. Williams' comment is developed on the basis of data from this latter paper.

22. David B. Houston and Richard M. Simon, "Economies of Scale in Financial Institutions: A Study in Life Insurance", *Econometrica,* Vol. 38, No. 6. (November, 1970).

23. In 1977 no company had premium income exceeding one million.

24. Lengyel, *op. cit.* p.28.

25. The reserve item discussed here is technically and functionally different from that appearing in the financial statements of a non-insurance firm. While in the latter case the retention of profits under the heading of 'reserves' is more or less a discretionary decision, for an insurance company the holding of reserve' is vital to its operation – and survival. Even if there were no legal stipulations governing the size of reserves (as is the case in several countries) an insurance company will still be constrained to hold resources (in trust as it were) commensurate with the level and nature of its liabilities.

26. These may contain resources not related to the company's insurance liabilities or stockholders' funds, and may therefore exceed the reserve provision.

27. Some domestic insurers also hold assets abroad relating to their local business.

28. In this respect, there are several firms that are still not complying with the legislation. Section 14 of the 1969 Insurance Act clearly states that a "registered insurer who carries on besides insurance any other business should keep separate accounts in respect of his insurance business, and shall segregate the assets and liabilities of his insurance business from those of his other business".

29. Lengyel, *op. cit.* p. 20.

30. During the late '60s/early '70s, this latter factor appeared to have been the more important in explaining insurance companies' small holding of Treasury Bills (generally less than 1 per cent of total outstandings). The uncertainties in the foreign exchange markets and the tightening up in Bahamian exchange control administration in this period had a significant effect on the preference function of the companies. In this context and given the narrow range of investment opportunities in the Bahamas the Treasury Bill assumed greater attraction.

31. See Central Bank of the Bahamas, *Quarterly Review,* Dec., 1978.

32. R.H. Pease and L.O. Kerwood, *Mortgage Banking, 2nd ed.,* New York; McGraw Hill Book Company, 1965, p. 70.

33. For example, the demand for this type of finance yields as opposed to returns from alternative investments; legal stipulations laying down maximum or minimum amounts which an insurer can carry.

34. All of them life companies. Not one of the exclusive non-life operators (and not surprisingly) showed any mortgage loans among its local assets.

35. One was primarily a mortgage lender doing its own underwriting.

36. Lengyel, *op. cit.* p. 55.

37. *Ibid.*

38. The Insurance Act, 1969, Para. 9, Sub Section (2).

39. For a comparative study see UNCTAD *Insurance Legislation and Supervision in Developing Countries,* New York, 1972, Sales No: E.72.11.D4.

40. A rate that would not only enable the company to cover its expenses but to compete with other insurers.

41. Incorporated in 1964.

42. These include Barbados, St. Lucia, Belize and Jamaica.

43. In 1977 only two other insurers had premium income exceeding that of this company.

44. The Insurance Act, 1969, Part II, Para. 5, Sub. Sect. 2.

45. *Ibid.,* Sub. Sect. 5.

46. Before the Insurance Act of 1969, there were two pieces of legislation governing insurance operations in the Bahamas. These were the Fire Insurance Company Tax Act which became effective in 1883 and which sought to impose a tax on the premium of all fire policies issued, in order to help meet the costs involved in running the Fire Department; and the Insurance Contract Act which placed on the government the responsibility for seeing that the insurance companies (excluding marine and fire insurers) had enought security to meet their contract obligations when called upon to do so. While under the former legislation the Treasurer was authorised to inspect the records of the insurance companies (who were subject to a penalty for not making returns), no one was appointed to enforce the latter Act, though a penalty was attached to violation of its provisions. (For a background discussion on these two laws, see speech delivered by Charles Donaldson, the former Registrar of Insurance, to the N.A.I.C. Meeting – Zone III on May 1, 1973).

47. A classic example was that of British Frontier General Assurance Limited which came to public attention in late 1969. The company was formed in Nassau around 1966, but operated exclusively in the United States, specialising among other things in marine and aviation coverage for corporations and businesses. More details are provided in *Business Insurance* of 13 October, 1969. "According to Federal officials, the company sold $10 m of woefully underpriced coverage since its inception in January, 1966. The figure cited represents premium volume, not coverage limits, and is considered 'highly conservative' by at least one authority. In the Alaskan area of Kodiak alone, it was learned, $50,000 in premium coverage was written on 20 risks. Marine coverage in Alaska was sold by representatives of British Frontier for 5 per cent of insured value. Normally such risks are rated at between 8 per cent and 14 per cent of insured value".

48. *The Nassau Tribune* Feb. 7, 1967.

49. UNCTAD, *Insurance Legislation and Supervision, op. cit.* p. 45.

50. *Ibid.*

51. *Terms of Shipment* U.N. Document TD/B/C. 4/36/Rev. . I, p.3.

52. *Ibid.*

53. In this regard it is interesting to note that several developing countries have in recent years laid down procedures which local exporters and importers are required to follow. Some Latin American states, for example, in order to encourage the growth of their merchant marines, reserve a proportion of their foreign trade for national flag carriers. Others like India require all imports to be insured locally.

54. The Report further goes on to state that at the end of 1972 assets invested by Canadian Life Companies on behalf of policy owners and annuitants in other countries totalled $5.6 billion, or roughly 30 per cent of the total assets of all federally registered life companies.

55. H.M.S.O , *Statistical Abstract,* 1979 edition.

56. Besides the loss of foreign exchange to the country there is the 'allocation effect' to be considered when an Insurance company, and particularly a life insurer, sends money abroad. In order to obtain the needed foreign exchange, the company has to give up local currency normally to a bank whose cash resources are then increased by the same amount. True, the bank may then be able to expand credit by a multiple of the sum received, but since its lending tends to be essentially of a short term nature, priority areas to which life insurance companies by the nature of their operations are better equipped to lend, become neglected in the process.

57. See *Sigma,* No. 10/Oct., 1972.

58. The list given here is by no means intended to be exhaustive. Some other transactions undertaken by insurance firms are by no means peculiar to their line of business (as are some listed above). At the time the money comes in, it is an inflow, and when it is subsequently repaid, it takes the form of an outflow. Again, in a case where an operator desires to acquire his own premises for the conduct of his business an inflow of capital may take place, and this will be reflected in the balance of payments.

59. Data used for compiling insurance flows for the balance of payments are derived largely from a form which the companies or their representatives in the Bahamas are required to fill and return to the Central Bank on a quarterly basis. Besides being too aggregative in the sense that it does not provide for sufficient details in respect of funds received or remitted abroad, the often poor response by insurers and the equally bad follow-up by the authorities result in a

very inadequate flow of data for balance of payments purposes. Not only should a new and more elaborate form be drawn up, but in cases where an agent handles more than one company, he should be required to submit a return for each company under his control, and not one for all of them, as happens at the moment. In this way, his figures can be double checked against the data in the foreign exchange department. As far as this latter department is concerned, there is urgent need for the institution of a data-gathering system which can provide the authorities with information which they might be unable to get directly from business concerns.

60. From the income/expenditure statement discussed earlier, it is possible to get an indication of the magnitude of at least two items: (a) Management expenses charged to Bahamas operations; and (b) Reinsurance (assuming that most of this service is obtained abroad as is no doubt the case in practice).

	Management Expenses Paid Abroad ($'000)	Reinsurance ($'000)
1971	1,657	814
1972	1,779	726
1973	1,899	1,368
1974	1,975	1,191
1975	1,975	1,634
1976	1,907	2,344
1977	2,717	1,960

61. Used here to describe the act of reserving to private local enterprise.

62. In both Ghana and India foreign concerns are permitted to write non-life business only. While, however, in the former, private institutions do all the life underwriting, in the latter this aspect of the business is reserved to the state monopoly.

63. To bring under state ownership.

64. See UNCTAD, *Insurance Legislation and Supervision, op. cit.* pp. 90–94.

65. M.A. Odle, *op. cit.* p. 71.

66. Generally the fees paid by insurance companies amount to less than 1 per cent of government's total recurrent reserve. Since 1976 the companies have been taxed to the tune of 1 per cent of their gross premiums. As the latter indicate the base is premium income and not the number of companies. In 1979 the premium tax is estimated to yield $600,000 as compared to $100,000 for fees.

67. In most developing countries this is inevitably the case since the local reinsurance market tends to be in a very underveloped state. One explanation for this situtation arises from the fact that the reinsurance business of foreign operators who have dominated the markets in these countries is normally handled by their head offices abroad.

68. UNCTAD, *Reinsurance Problems in Developing Countries,* Sales No: E. 74.11.D2.

69. *Ibid.,* p. 32.

70. *Ibid.;* p. 33.

71. *Ibid.,* pp. 35–36.

72. The point was forcefully made in the African Development Bank's Study, *Report of the Expert Group on Insurance and Reinsurance Business in Africa* (8 March, 1968): "When considering the possibility of creating reinsurance arrangements at a national level the question of optimum minimum market arises; unless the volume of premium has reached a suitable level, administrative expenses will be disproportionately high. Consideration of reinsurance arrangements should not be confined to a narrow national framework only because of the axiom that the bigger the market and the more varied the risks covered, the larger the retention capacity achieved under optimum considerations. On the other hand, projects not economically feasible at the individual country level become practical propositions if undertaken at the level of the region". (Quoted in UN Reinsurance Document cited, p. 41).

73. UNCTAD Reinsurnace Document, *op. cit.,* p. 40.

74. In this connection it is worth noting that a House of Assembly Select Committee was set up in mid-1978 to study the insurance industry, taking into consideration all matters pertaining to, connected with and incidental to life, other than life, property and vehicular insurance in the Bahamas. One issue pointed out for urgent thought was mandatory investments by insurance

companies in the Bahamas.

75. Within such a framework the occurence of a situation where a company refuses to renew its licence while holding policies in force could more easily be dealt with.

76. Two were inactive.

77. F. Reiss, "Corporations and the Captive Insurer". Paper published in the Proceedings of the Twelfth Annual Insurance Conferences, sponsored by the College of Commerce and Administration, The Ohio State University, March 9 – 10, 1971.

78. R Goshay, "Captive Insurance Companies", in H. Wayne Snider (ed.), *Risk Management* Illionis, Richard D. Irwin Inc. 1964.

79. *Ibid.*

80. See J.A. Dixon, "What is a Captive Insurer?" *The Review,* June 27, 1969, for a discussion of this point.

81. Goshay, *op. cit.*

82. *Ibid.*

83. William Sherar, "The Role of the Captive Insurance Company." *Risk Management,* January, 1972.

84. R.J. McRell, *Self Insurance and Captive Subsidiary Concepts,* New York, The Journal of Commerce, 1973.

85. This is the more common arrangement. However, in cases where insurance tends to be unavailable, either because of the type of risk or the amount of liability, a funded programme can be set up.

86. As indicated earlier, for a small company wishing to write a large portfolio, reinsurance is inevitable if it is not to run into insolvency problems. Besides capacity, reinsurance can be undertaken for other reasons, e.g. financing, stabilisation and catastrophe protection.

87. Goshay, *op. cit.*

88. In many jurisdictions there are regulations specifying minimum capital and surplus requirements for insurance companies. In New York and a number of other U.S. States, for example, the 'Kinney Rule' which states that net retention after reinsurance should not exceed one-tenth of the capital and surplus of the company is known to apply. Insurance companies, like other entities, have to comply with the legislative requirements of the countries where they operate, and these determine the minimum capitalisation of the companies. In practice however, the operating structures of carriers would tend to be influenced, above all else, by the volume and nature of the business they intend to retain. For 'captives' whose business is confined to the risk of the parent, experts suggest a much more stringent relationship between net retention and capital and surplus than that of the Kinney formula. Ratios ranging between 2½ and 4 to 1 have been put forward from time to time. However, whatever the relationship adopted, insurance subsidiaries need to be well capitalised and financed, if they hope to induce reinsurers to participate in their underwriting activities.

89. Only paid losses are recognised for tax purposes.

90. It has been estimated that the average cost of sale of direct insurers can be as much as 30 per cent of the original net premium, Reiss, *op. cit.*

91. For example, oil tankers, war damage, product recall, flood, loss of contract, confiscation, devaluation and pollution.

92. See Marianne Burge, "Captives: Bermuda, Colorado, Taxes and Beyond", *Business Insurance,* April 10, 1972.

93. Bob Carter, "Prospects for Captives", *Policy Holder Insurance Journal,* July 31, 1970.

94. Charles H. Groves, "Using a Captive to Insure Hard-to-Place Risks", *Best's Review,* June 1972.

95. J.W. Sherar, "The Role of the Captive Insurance Company", *Risk Management,* January, 1972.

96. Of course, profits are taxable when they are repatriated to the United States. However, by choosing the most appropriate time in the context of the parent company's earnings, the tax burden can be considerably reduced. It might be mentioned, too, while on the subject of taxation, that in the event of dissolution of the 'captive' the proceeds are taxable at the capital gains rate only.

97. In other words, protection against financial loss at costs lower than those prevailing in the conventional insurance markets.

98. *Ibid.* p. 97.

98. S R. Pine, "Captive Foreign Insurance Companies" in *Foreign Tax Havens,* Practising Law Institute, New York, 1973.

99. *Ibid.* p. 97.

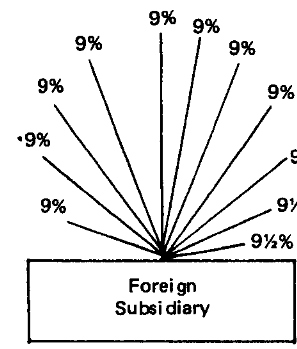
100. Charles Donaldson, "Captive in Bahamas", *The Spectator,* April, 1972.

101 *Business Insurance,* June 10, 1974.

102. *Ibid.*

103. *Ibid.*

104 For this purpose a U.S. shareholder is defined as a U.S. citizen, resident, domestic corporation, partnership or trust that owns 10 per cent or more of the voting power of such a corporation. The implication of this definition is that a foreign subsidiary may be controlled by several U.S. companies or individual, but because of the way the shares are distributed, this subsidiary will not be deemed a "controlled foreign corporation", and therefore will not be liable to taxation on its current income in the U.S., even when all its income is derived from U.S. risks. For example, U S. shareholders owning a foreign company on the following basis will qualify for exemption.



105. Sidney Pine, "The Case for 'Captive' Insurers", *Harvard Business Review,* November-December, 1972.

106. IRS Manual Supplement, 42 G-256, issued Jan. 10, 1972.

107. This is extended to the reinsurance portion of the premiums paid to a 'captive'.

108. See S. Pine, in Practising Law Institute, *op. cit.*

109. 'Bona fide' in this context would generally be taken to mean: (a) a subsidiary engaged in actual insurance work involving the parent's risks and perhaps exposures outside this limit; (b) reasonable capitalisation; (c) an actual transfer of risk must take place with the payment of premiums; and (d) the cost of the insurance service provided the parent should be within reasonable limits, i.e. comparable to arms length dealings.

110. These include a 4 per cent excise penalty charge and in some instances a 3 per cent surplus lines tax.

111. In 1977, Tennessee became the second state to pass a bill with the aim of facilitating the setting up of captive insurance companies. Minnesota is reportedly planning to become the third.

112. In the case of an 'association captive' the corresponding figure is $1 million.

113. 'Offshore' companies are formed under the Exempted Companies Act of 1950.

114. Exempted Companies whose shareholders are not resident in Bermuda are not subject to exchange control.

115. Also called mickey mousers and toy factories in Bermuda.

116. See comments by Fred Reiss (President of American Risk Management) appearing in *Business Insurance*, of 18 August, 1969.

117. It should be noted, however, that the Act did not discriminate against them either, though their operations clearly stood to be affected by the logic of it.

118. The Insurance Act, 1969, Part II, Section 5, para. 3.

CHAPTER 4

OTHER FINANCIAL INSTITUTIONS

In this chapter we shall discuss a group of financial institutions which, with insurance companies, comprise the so-called 'non-bank intermediary' sector in the Bahamas. While we have included an analysis of the legal structure and functions of the Bahamas Development Bank (BDB) in the chapter, it should be pointed out that this institution is not, technically speaking, a part of the group normally referred to as 'non-bank financial intermediaries' as this term has come to be used in the literature. As we shall see, the BDB is a special type of entity designed by the government to assist in achieving certain specific developmental objectives through the provision of long term finance and advisory services of a technical nature.

Introduction

As a result of the rapid growth of non-bank financial intermediaries (such as insurance companies, savings and loan associations, credit unions, savings banks, finance and hire-purchase companies, etc.) in a number of developed countries since the turn of the century, and particularly in more recent years, a lively debate has sprung up among economists about the significance of this development for monetary policy which, traditionally, has been aimed mainly at the commercial banks. A related concern in this discussion, which not unexpectedly has now spread to the developing countries where efforts are being made to develop monetary control apparatus similar to those prevailing in the developed nations, is the question of equity in financial regulations (which in many countries have discriminated against the commercial banks), and the effects of these regulations on the financial structure.

Without wishing to delve too deeply into the wide body of literature which has arisen on the subject of non-bank financial intermediaries, it is appropriate to outline, briefly, some of the issues arising from their growth, since these have some relevance to the Bahamas.

For a long time a major distinction made between commercial banks and other financial institutions was the importance of the former in the payments mechanism, i.e. their ability to create money. While generally non-bank intermediaries do not operate chequeing accounts, the view is now widely accepted that they perform much more than a brokerage function, since they are able to create credit through a 'multiplier' process in essentially the same way as banks.[1] In this "new view", as Tobin calls it, an attempt is made "to blur the distinction between money and other assets and between commercial banks and other intermediaries; to focus on demands for and supplies of the whole spectrum of assets rather than on the quantity and velocity of 'money'; and to regard the structure of interest rates, asset yields and credit availabilities, rather than the quantity of money as the linkage between monetary and financial institutions and policies on the one hand and the real economy of the other".[2] The difference between commercial banks and other financial institutions, it is argued, is one of degree rather than kind, and such differences which do exist "have little intrinsically to do with the monetary nature of bank liabilities."[3]

This hypothesis[4] which is most closely associated with the names of John Gurley and Edward Shaw has not been uncritically accepted in the academic world, and efforts have been made to subject some aspects of it to empirical testing. In a study published in 1964, Edgar Feige[5] using temporal cross-section data of liquid asset holdings by states (in the U.S.) for the period 1949-1959 concluded that the liabilities of non-bank intermediaries are not substitutable for money. This conclusion, however, was rejected by Lee[6] using the same data supplemented by material from other sources. On the basis of his results, Lee strongly contends that the "demand for money is negatively related to changes in yields on non-bank intermediary liabilities, and it has in fact been reduced by quality changes in non-bank intermediary liabilities. . ."[7] This conclusion, he has also pointed out, is in direct conflict with the Friedman-Schwartz position[8] which maintains that while time deposits are close, if not perfect substitutes for demand deposits, the demand for either sight deposits or time deposits is independent of the demand for non-bank intermediary liabilities. A number of other studies[9] carried out by economists, indicate that opinion on the substitutability hypothesis as it relates to money and the liabilities of non-bank financial institutions is far from unanimous. A major factor responsible for this situation, it should be pointed out, arises from the differences in methods used in the empirical analysis in determining the shape of consumers indiference curves for the various types of monetary assets.[10]

The degree to which the liabilities of non-bank intermediaries can be substituted for the liabilities of commercial banks can have serious implications for monetary policy, particularly in view of their increasing size vis-a-vis commercial banks in the financial system of many countries. Analysing the experience of the United States in the late '50s, Smith concluded that there was "no evidence of systematic destabilising shifts between demand deposits and claims against other intermediaries such as mutual savings banks and savings and loan associations",[11] and there was therefore no grounds (at least not as yet) for the extension of Federal Reserve control to these institutions. The Radcliffe Committee too, while admitting by its frequent resort to a 'general' or 'over-all' liquidity concept that near-money assets could not be ignored in monetary policy decisions, nevertheless, appeared to have felt that in the short term the banks should be the major institution for control, even though there were certain recognised shortcomings to too restrictive a policy.

> *. . . regulation of the banks is required not because they are 'creators of money' but because they are the biggest lenders at the shortest (most liquid) end of the range of credit markets. Any severely restrictive control of their operations is certain over a period of time, to be defeated by the development of rival institutions; during the interim, the community will have suffered loss by interference with the most efficient channels of lending.*[12]

From a strictly monetary control point of view, this same kind of thinking would appear to underlie the approach of a great many countries, though in several instances there might be additional factors involved in explaining the attention paid to banks, such as the insignificance of other institutions in the financial structure, or purely historical reasons that in many cases have probably been made obsolete by modern developments. It is significant to note here that although economists have gone to great lengths to draw attention to the increasingly obtrusive position of non-bank institutions in the financial system and the implications for credit expansion, there has been no suggestion that the growth of these institutions (which in some instances has outpaced that of commercial banks), should be stunted. Such recommendations as have been made (and adopted by some countries) often relate to the need to bring the non-bank intermediaries in line with the commercial banks by imposing reserve requirements, or alternatively to the promotion of fair competition by removing some of the prevailing restrictions on banking organisations.

While these questions, until perhaps quite recently, assumed fairly large proportions in the developed nations, in the developing countries the focus has been on financial institutions more in the capacity of intermediaries in the savings-investment process, rather than in their role as credit creators. The main reason for this, of course, is to be found in the over-riding concern with questions of economic development in these countries, where the mobilisation and dissemination of financial resources are a central issue. While a financial system is not the only means available to mobilise savings, for a number of reasons it tends to be an extremely important one in developing countries, particularly in situations where the government sector is quite small, or the inflation technique is not feasible. For this reason a large part of resources is devoted to the building up of the money and capital markets in an effort to accelerate the pace of development in which efficient financial intermediation is envisaged as having a crucial role to play.

We need to point out, however, that the importance of financial intermediation to economic progress is founded on certain principles to which institutions may, and often fail to conform in practice. An essential function of financial intermediaries that is often cited, is to facilitate the transfer of resources from surplus spending units to deficit spending units in a situation where decisions to save and decisions to invest are made by different people.

From the community's point of view, however, there are other aspects of this basic function that are of critical importance in the development process. These include "their impact on the growth of savings, especially of the household sector; second, their role in the financialisation of these savings (that is, savings in a financial form); and third, their ability to ensure the most efficient transformation of mobilised funds into real capital".[13] As stated, the first two points imply much more than the mere collection of savings. They suggest in a critical sense an active role on the part of financial institutions to encourage savings through, not only the provision of facilities, but by making available to the public a range of assets differentiated in terms of liquidity, safety and returns to holders, and thus, appealing to a wider spectrum of savers, who, otherwise, would be confronted with a very narrow choice in the media available for accumulating surplus resources. The third point which refers to the allocative function of financial intermediaries is no less important than the other two. The areas where savings institutions channel their funds, however may not coincide with those where resources are most needed from the community's point of view. "Financial institutions, being profit maximizers, tend to seek avenues for employment of their funds where the profit rate is high, the risk of non-repayment small, and the cost of administering loans low. In that event, funds would not always flow to the socially most efficient sectors." [14] In situations, therefore, where a substantial part of the community's savings flow through the financial system, the behaviour of the latter must be influenced if success is to be attained in any development strategy involving the encouragement of indigenous entrepreneurs and the stimulation of lagging sectors, to the extent that the lack of credit is a debilitating factor in this effort.

In many developing countries where the financial sector has long been dominated by foreign enterprises, the problem of 'inefficient' allocation is even more pronounced as the operations of these institutions have been guided by certain narrow viewpoints which have discriminated in no uncertain way against indigenous credit seekers, and in this way the financial sector has played no small part in perpetuating underdevelopment and dependence, and in encouraging structures that contribute little to the solution of the basic problems facing these societies. For this reason, measures to affect the policies of the financial sector are often regarded as an integral part of the efforts aimed at transforming the real sectors of the economy and improving the general climate for greater local initiative.

In a recent study, Edward Shaw has placed overwhelming emphasis on the role of the financial sector in economic development, arguing that "financial repression" is a key factor in retarding growth and "intercepting impulses to development".[15] Financial repression takes many forms but, essentially, the consequences of this phenomenon are a failure to tap the full savings potential of the community and a sub-optional use of resources, the result being a suppression in the growth of real income and social welfare. While some tinkering with the financial system has been undertaken in a number of developing countries, particularly since independence, fundamental reforms in many cases have received relatively low priority in development programmes, with the result that financial institutions continue to function in basically the same old colonial framework and with the same ethos as before. In such situations, the force of conservatism can be so strong that isolated attempts by forward-looking institutions to take on a more dynamic role will often be looked upon with disdain by the rest of the financial community (and often the local governmental authorities) who may tend to see such attempts as an effort to disturb the existing 'financial tranquillity', rather than as a move to forge policies consistent with with a rapidily changing environment. The collusion of government authorities in repressive actions is often easily secured through the technique which seeks to equate private interests with the 'national good' and privileged minorities with the wider community. This is all the more likely in situations where there is a high degree of uncertainty in governmental policy, and no clear set of objectives to which various aspects of economic decision-making could relate.

Finally, we should note that there is a direct relationship between financial repression and external dependence in that failure to mobilise the community's savings, and to increase the level of savings, can lead to heavy reliance on foreign investment and foreign aid which often tend to be provided on terms that serve to deepen underdevelopment rather than assist in breaking the low-savings low-income, low-savings vicious circle that characterises developing countries. The fact that foreign aid itself may be made available at subsided costs can act as a disincentive to the mobilisation of domestic resources, and in this way contributes to the dependence on external sources for capital funds.

THE FINANCE COMPANIES

The finance companies, which are largely an outgrowth of the 1950s and 1960s, form a heterogeneous group. The four known to be engaged in domestic activity in the Bahamas can be listed (in order of formation) as follows: 1. Finance Corporation of the Bahamas Limited (FINCO); 2. Commonwealth Industrial Bank Limited; 3. Barclay's Bank Finance Corporation (Bahamas) Limited; 4. First Home Savings and Loan Limited.

There is a fifth company which specialises in hire-purchase finance, with particular emphasis on automobile sales. With the exception of 1972 (when total assets were less than $5 million), we have no information, whatever, on this particular company for any other period. For this reason, we have not included it in the analysis. In 1978, one of the bigger operators in the personal finance business (International Bank of Washington (Bahamas) Limited) went into voluntary liquidation. From the early 1960s, this institution had served as the head office for International Bank's other operations in the Caribbean Area, which also have been considerably reduced in recent years.

Finance Corporation of the Bahamas Limited came into existence in 1953 as a mortgage and hire-purchase firm. It continued to operate in this way until 1958 when it became an exclusive mortgage lender. Its growth since then has been nothing short of phenomenal; total assets of the company increasing from about $3 million at the end of the 1950s to between $14 million and $15 million by 1966 and to over $70 million at the end of 1978. According to an official of the firm, its basic function is "to try and generate enough local Bahamian dollar deposits to meet the continuing demand for the financing of local housing"[16] which is the company's main area of interest. Almost all its loans are made for residential purposes. The company has stated that most of its funds have been applied to the building of medium and lower medium priced homes with values in the range of $25,000 to $40,000.[17] Commonwealth Industrial Bank (CIB) started business as a consumer instalment and mortgage lending company, which it still is, though under a slightly different organisation. Subsequent to its formation, another company was incorporated (Laurentide Insurance and Mortgage) to handle the mortgage aspect of the firm's local business. This move to establish a new entity seems to have been motivated purely by administrative and accounting convenience, since it appears that its operations are still handled by the parent firm, CIB, which concentrates on personal loans mainly on an instalment basis and to a lesser extent through hire-purchase agreements. According to an advertisement appearing regularly in the local media it "makes loans for any useful purpose". Barclay's Bank Finance Corporation was originally conceived as an institution for financing low cost housing. Its current interest is still exclusively in the mortgage field, the purpose of the company being "to provide mortgage on an owner-occupied system to Bahamians only".[18] First Home Savings and Loan Limited was formed in 1978 to engage in mortgage financing which appears to be its main activity at the moment.

All the firms listed above are currently under foreign ownership. FINCO, established in 1953, is now a wholly-owned subsidiary of the Roywest Banking Corporation which was set up in 1965 as a consortium bank[19]. Commonwealth Industrial Bank (CIB) was incorporated (with minority Bahamian interest) in May of 1960 as a subsidiary of Laurentide Financial Corporation Limited of Canada which, as indicated earlier, also owns another company operating in the local market under the style of Laurentide Insurance and Mortgage Company.[20] The latter, it is understood, operates very closely with its sister firm, CIB, which also holds all the stocks in Laurentide Finance Company Limited, a consumer type lending company incorporated in Jamaica in 1964. First Home Savings and Loan Limited, formed in 1978, is a subsidiary of British-American Insurance Company which is a foreign owned company, though it operates out of the Bahamas. The entity that is known as Barclay's Bank Finance Corporation has its origin in a joint undertaking (BOLAM Barclay's Finance Corporation (Bahamas) Limited, sometimes called Bolabar) that was initiated in 1965 between Barclay's Bank and the Bank of London and Montreal. The present name was taken in June 1970 when the company became a wholly-owned subsidiary of Barclay's Bank International Limited.

Assets Structure of Finance Companies

Between the end of 1968 and the end of 1978, the total assets of the finance companies increased from $44.1 million to $91.9 million or by 108 per cent. The average growth rate over the period in current value was 6.8 per cent.

Whilst overall this expansion does not seem particularly spectacular, especially when movements in prices are taken into account, a glance at Table 4.1 shows that the growth rate of assets of the various companies has not been uniform. For example, while the total resources of Firm 4 increased by more than 400 per cent over the period, the assets of Firm 1 grew by less than 100 per cent.

An examination of Table 4.2 shows that at the end of 1978, assets held by the finance companies were almost exclusively payable in Bahamian dollars. This contrasts sharply with the situation in earlier years when a fairly significant part of total assets was denominated in foreign currency. One company (no longer in operation) in particular accounted for the bulk of the non-Bahamian dollar component of the balance sheet. It should be pointed out that not all the foreign currency assets held by the company were related to its Bahamian business. Another point to note with respect to Table 4.2 is that at the end of 1978, the finance companies (with which we are concerned) held virtually no foreign assets. This situation reflects the extent to which their resources are employed locally.

According to Table 4.2, B$ mortgages outstanding increased from $33.8 million (73 per cent of total B$ assets) at the end of 1973 to $67.6 million (73.5 per cent of total assets) at the end of 1978. From this it would appear that mortgage loans have grown at roughly the same pace as total assets. 'Other Loans and Advances' (which are mainly personal loans) grew less fast than mortgages over the period, moving from $4.3 million (9.3 per cent of total B$ assets) at the end of 1973 to $6.6 million (7.2 per cent of assets) at the end of 1978. Hire-purchase accounts continue to occupy a very insignificant position in the operations of the finance houses. At the end of 1978, these accounts amounted to less than 1 per cent of total assets outstanding. Investment in Government long term securities appears to be an increasingly attractive outlet for funds held by the companies. The main explanation for this development may stem from the need to attain some degree of diversification in the portfolio of assets rather than from differences in the rates of return among competing opportunities. An additional factor may be the unavailability of enough creditworthy mortgage borrowers. At the end of 1978 Government securities

TABLE 4.1

GROWTH IN ASSETS[a] OF FINANCE COMPANIES, 1968–1978
(End of Year Figures)

B$'000

Firms	1968	1970	1972	1974	1976	1978	Change 1968-78 $'000	%
1	4,021	7,395	7,964	8,273	5,070	7,336	3,315	82.4
2	na	na	4,568	na	na	na	na	na
3	14,186	11,995	17,017	15,661	14,595	–	(-14,186)	(-100)
4	2,061	5,933[b]	10,117	11,248	10,167	10,507	8,446	409.8
5[c]	23,848	28,361	28,016	44,537	55,460	71,084	47,236	198.1
6	–	–	–	–	–	2,994	2,994	100.0
Total[d]	**44,116**	**53,684**	**67,682**	**79,719**	**85,292**	**91,921**		

a: These figures include both Bahamian dollar and foreign currency assets.

b: Position at the end of September.

c: Figures relating to years prior to 1974 represent position at the end of September.

d: With the exception of 1972 totals relate to four companies.

Source: *Annual Accounts* and Returns to Central Bank of the Bahamas.

TABLE 4.2

ASSETS COMPOSITION OF FINANCE COMPANIES 1973 AND 1978

$'000	1973 (end)			1978 (end)		
Assets	**Payable in B$**	**Payable in Foreign currency**	**Total**	**Payable in B$**	**Payable in Foreign currency**	**Total**
Notes & Coin Hand	24	67	91	31	–	31
Balance with Central Bank	–	–	–	3,234	–	3,234
Balance with Financial Institutions						
in Bahamas: Sight Deposits	468	5	473	2,542	–	2,542
Fixed	1,100	1,964	3,064	3,292	–	3,292
Due from Head Office or	–	3,404	3,404	–	–	–
Financial Institutions						
outside the Bahamas	–	633	633	–	–	–
Mortgage Loans:						
Local	33,789	149	33,938	67,573	–	67,573
Non-Local	–	323	323	–	–	–
Hire-Purchase Accounts	372	–	372	252	–	252
Other Loans &						
Advances: Local	4,263	–	4,263	6,559	–	6,559
Non-Local	–	170	170	–	–	–
Claims on Government:						
(Tr. Bills)	1,750	–	1,750	–	–	–
Other	200	–	200	7,527	–	7,527
Investment in Stocks & Shares:						
Local	300	1,199	1,499	300	–	300
Foreign	–	6,658	6,658	–	–	–
Premiums & Other						
Fixed Assets	232	–	232	264	–	264
Other Assets	3,584	–	3,584	347	–	347
Total Assets	**46,082**	**14,572**	**60,654**	**91,921**	–	**91,921**

Source: Central Bank of the Bahamas

held amounted to 8.2 per cent of total assets. Funds placed with the Central Bank and other financial institutions in the Bahamas contributed 3.5 per cent and 6.3 per cent respectively to overall assets.

The Liabilities Structure of the Finance Companies

Like the assets side of the balance sheet, the liabilities section has both a local and a foreign currency component. The consolidated position of four firms at the end of 1978 is presented in Table 4.3. A comparison of this table with Table 4.2 shows that at the end of 1978, Bahamian dollar assets were in excess of Bahamian dollar liabilities by $7.0 million, implying that foreign currency was converted into the local medium for carrying out domestic transactions. Part of this foreign conversion element takes the form of 'approved investment' which simply means that the authorities have guaranteed the repatriation of the resources involved, whenever this may be desired.

Table 4.3 gives an indication of the main sources from which the finance companies as a group derive their resources. At the end of 1973, B$ deposits from the public amounted to 73.8 per cent of total B$ liabilities, as compared to 81 per cent at the end of 1978. The major portion of these deposits fall in the 'savings and fixed' category. This applies particularly to the firms engaged in long term lending. Deposits from other financial institutions (including related companies) in the Bahamas tend to form a fairly small part of the total liabilities. For the group, taken as a whole, borrowing (either in Bahamian dollars or foreign currency) does not appear to be a major source of funds, though its importance varies from one company to another. Resources outstanding from this medium at the end of 1978 amounted to 9.5 per cent of total liabilities. Capital and reserves have increased at a fairly slow pace over recent years. The level of activity has been significantly influenced by funds which the companies have been able to attract from the public.

Of the four firms under discussion, three, as indicated earlier, are essentially mortgage finance companies. Deposits for these companies provide the major source of funds. While the type of deposits attracted has undoubtedly, a strong effect on lending policies, the fact that these firms are all owned by large and powerful financial organisations may also influence the maturity structure of their respective loans portfolio. In the event of a liquidity problem, the parent stands as the lender of last resort. The firm specialising in the making of personal loans relies on funds provided both by deposits and the parent. The amount of borrowing undertaken depends on the volume of lending being done, the latter being influenced to a significant degree by local economic conditions and more immediately by the number of credit-worthy borrowers seeking loans.

TABLE 4.3

LIABILITIES COMPOSITION OF FINANCE COMPANIES, 1973 AND 1978

Liabilities	1973 (end)			1978 (end)		
	Payable in B$	Payable in Foreign currency	Total	Payable in $B	Payable in Foreign currency	Total
Demand Deposits	2	6	8	3,408	–	3,408
Fixed & Savings	33,872	69	33,941	65,354	–	65,354
Non-Local Deposits	–	5,028	5,028	–	–	–
Due to Financial Institutions in Bahamas						
Sight	144	–	144	92	–	92
Fixed	1,376	–	1,376	2,087	–	2,087
Borrowings	1,984	3,575	5,559	1,726	–	1,726
Due to Offshore Financial Institutions in Bahamas	–	–	–	–	7,039	7,039
Due to Financial Institutions Outside the Bahamas (H/Office)	–	6,024	6,024	–	29	29
Others	–	–	–	–	–	–
Capital & Reserves	7,463	–	7,463	9,209	–	9,209
Other Liabilities	1,111	–	1,111	2,977	–	2,977
Total	**45,952**	**14,702**	**60,654**	**84,853**	**7,068**	**91,921**

Source: Central Bank of the Bahamas.

THE POST OFFICE SAVINGS BANK

The Post Office Savings Bank in Historical Perspective

The Post Office Savings Bank (POSB) was established in the Bahamas by the Post Office Savings Bank Act of 1885,[21] apparently in anticipation of the closure of the Public Bank of the Bahamas[22] (PBB) which was in the course of winding up its operations, having been in existence for a period of a little under 50 years, during which time no new banks were opened. The decision to close the PBB therefore would have left the country without a savings institution of any kind, and it was, undoubtedly, the realisation of this fact that prompted the introduction of the POSB which it was believed could provide this facility without the accompanying difficulties involved in more complex banking operations. It was felt that the POSB would be able to reach out to a larger number of the 'labouring' population than the PBB could ever have hoped to do, given its particular structure and objectives.

Broadly, there are three phases which can be discerned in the twentieth century history of the Post Office Savings Bank in the Bahamas. The first phase which can be described as a period of relatively slow growth[23] came to a close, it would appear, with the end of the Second World War. A glance at Table 4.4 shows that the number of depositors increased from 1,350 in 1900 to 9,038 in 1939 or by 7,688 in this 39-year period. In contrast to this, the absolute increase in depositors in the 25-years between 1939 and 1964 was 27,399. This second phase which actually began in the immediate postwar years with the rise in economic activities based on the inflow of British (and later American) capital and the re-establishment of the tourist industry, can be called the expansionary phase. The third and final phase, which began around the early '60s (if we are to judge from the no. of deposits' figures) can be termed the declining years. In the sections immediately following, we shall discuss briefly some of the factors which have accounted for the emergence of each of these phases, and then go on to outline the legal structure of the institution and the future role envisaged for it.

At the beginning of the present century the position of the Post Office Savings Bank when looked at in the context of the total population of the country seemed to have been one of relative insignificance. In 1900, the number of active accounts maintained was in the region of 1,000 which represented about 2 per cent of the population of the day. The proportion, however, notwithstanding the presence of two commercial banks,[24] gradually increased over the following two decades as the number of branches expanded to cover a larger area of the country. Some indices of this expansion are presented in Table 4.4. which shows that active accounts as a percentage of population grew from 2 per cent in 1900 to 5 per cent in 1920 and to 8 per cent in 1933. By 1965, the proportion had climbed to 20 per cent. Since then, there has been a gradual decline, even though up to 1974 the average balance per account appears to have been increasing, the figure

TABLE 4.4

ACTIVE ACCOUNTS AT THE POSB AS A % OF POPULATION, AND GROWTH IN DEPOSITORS' BALANCES, 1900 TO 1978

Year Ending 30 June	(1) Active Accounts[a]	(2) Population	(3) (1) as a % of (2)	(4) Depositors' Balances $	(5) Average Balance per A/C $
1900[b]	1,000	53,735[c]	1.9	43,534	43.52
1913	1,866	55,944[d]	3.3	74,856	40.11
1920	2,699	53,031[e]	5.0	93,367	34.59
1933	5,000	59,828[f]	8.3	163,669	32.73
1965	26,189	142,000[g]	20.1	2,361,093	90.15
1970	18,986	173,000	11.0	2,753,068	145.00
1973	15,734	193,000	8.1	2,286,221	145.30
1974	15,876	202,000	7.8	2,236,169	140.85
1975	15,507	208,000	7.4	2,158,072	139.17
1976	15,763	216,000	7.3	2,119,359	134.45
1977	16,180	224,000	7.2	2,060,092	127.32
1978	16,332	230,000	7.1	2,074,519	127.02

a: These figures are to be regarded as very rough estimates.

b: Year end position.

c: 1901; d: 1911; e: 1921; f: 1931; g: Figures for 1965 onwards are end of year estimates

Sources: Department of Statistics, *Population Census Report 1970;* Post Office Savings Bank, *Annual Reports;* Colonial Office Reports; Department of Statistics, *Quarterly Statistical Summary,* 2nd Quarter, 1978.

moving from $90.15 in 1965 to $140.85 in 1974. The average has continued to decline in more recent years.

A better indication of the various phases through which the POSB has passed can perhaps be found in an examination of the figures relating to the number of depositors, deposits and withdrawals over the years. These statistics are - with certain gaps - presented in Table 4.5 which provides some insights into the pattern of growth of the POSB over the period 1888 to 1977. The extremely slow growth of the POSB in the first two decades of the century can be attributed largely to the state of the economy during this period. There was no doubt, however, that the advent of a new and experienced institution was also a contributory factor. The tendency for withdrawals to exceed deposits almost continuously between 1909 and 1917 reflects the unmistakable impact of the Royal Bank of Canada which entered the scene in 1908. The terms and facilities offered by Royal and the Bank of Nassau were undoubtedly more attractive than those offered by the POSB which was also handicapped by the limits placed on the amounts anyone could hold in an account, or could deposit in any one year. The situation is reflected in Table 4.6 which shows that between 1909 and 1915, while total depositors' balance at the POSB tended to decline, those at the Royal tended to move in the opposite direction. Deposits at the Bank of Nassau increased until 1914 and then seemed to have fallen off, a situation no doubt reflecting the difficulties in which this bank was caught around that time. It should be noted that despite the inferior facilities offered by the POSB, even this institution was to benefit from the boom conditons experienced in the Bahamas during the 1920s and early '30s as a result of the 'bootlegging' activities to which Prohibition in the United States gave rise. As can be seen in Table 4.5, while the number of depositors increased by 932 between 1905 and 1919, the corresponding figure for the period between 1919 and 1933 was 3,215. While in relative terms this growth may look impressive, an examination of Table 4.5 shows that the really significant expansion in the business of the POSB took place in the period after the Second World War.

Before going on to discuss the other two phases to which reference was made earlier, a word should be said on the spread of the Post Office Bank's offices, which obviously would tend to be a critical factor in the institution's ability to attract depositors, particularly in view of the physical layout of the country.

Until 1910, branches of the POSB existed in only a few of the islands that comprise the Bahamas. During that year, however, offices were opened in several of the major out islands which then accounted for 21 of the total number of branches being operated by the bank. Initially, the introduction of the Post Office Savings Bank in the out islands seemed to have had only a limited impact on the population, the majority of whom preferred to deal directly with the office in Nassau, or either hoard or bury their money. The latter practices were belived to be fairly widespread not only in the out

TABLE 4.5

GROWTH IN THE NUMBER OF DEPOSITORS AND DEPOSITORS' BALANCE AT THE POSB, 1888 TO 1978

BS

Year Ending 30 June[a]	No. of Depositors	Balances due to Depositors	Deposits		Withdrawals	
			No.	Amt.	No.	Amt.
1888	463	na	8,193	na	4,865	15,782
1898	1,107	na	13,734	na	11,839	29,759
1900	1,350	na	21,687	na	16,436	43,534
1905	1,864	3,751	29,847	2,216	20,776	na
1908	2,297	4,524	37,895	3,150	34,581	90,361
1909	2,179	3,811	27,936	3,098	38,464	81,833
1910	2,186	2,946	19,650	2,632	25,488	79,276
1911	2,108	2,788	19,065	2,357	26,642	72,848
1912	2,180	3,038	21,459	1,985	21,168	74,836
1913	2,361	3,764	25,427	2,204	27,050	74,856
1914	2,455	3,698	24,262	2,568	24,790	76,082
1915	2,434	2,871	17,391	2,828	26,990	68,091
1916	na	3,772	20,084	2,116	22,907	na
1919	2,796	3,885	31,798	3,405	23,396	78,270
1920	3,280	4,412	46,975	3,461	34,127	93,367
1925	4,286	na	64,499	na	62,448	155,547
1930	5,576	na	55,803	na	66,315	159,933

1933	6,011	na	43,644	na	48,892	163,669
1939	9,038	na	129,139	na	113,326	229,477
1947	na	na	na	na	na	1,031,776
1950	24,638	na	na	na	na	1,089,379
1955	30,298	na	na	na	na	1,578,401
1960	35,044	35,668	1,438,478	31,714	1,259,140	2,406,748
1964	36,437	21,373	1,001,347	21,992	1,012,715	2,290.574
1965	36,228	20,952	1,007,798	19,931	990,051	2,361,093
1966	36,426	19,749	995,274	18,054	1,001,181	2,410,694
1967	31,067	16,884	991,402	13,884	920,563	2,539,236
1968	28,113	13,875	884,717	12,351	907,292	2,575,870
1969	28,813	13,426	982,142	10,384	891,662	2,727,709
1970	28,986	11,837	954,767	9,660	993,260	2,753,068
1971	34,642	9,717	818,064	10,250	999,783	2,633,711
1972	34,831	7,476	597,159	8,636	885,712	2,404,282
1973	34,899	6,560	555,820	7,193	723,713	2,286,221
1974	34,934	6,259	559,234	6,891	661,119	2,236,169
1975	34,441	5,397	513,336	6,407	643,001	2,158,072
1976	34,556	5,295	485,992	5,898	574,145	2,119,359
1977	34,718	6,089	481,317	5,789	589,637	2,060,092
1978	34,632	5,584	570,333	5,538	603,853	2,074,520

a: Exceptions are 1888 to 1901, figures for which relate to the calendar year.

Source: *Post* Office Savings Bank *Annual Reports;* Colonial Office Reports.

islands but even in Nassau itself, particularly after the end of the First World War when the islands' economy received a slight boost from the high prices that were being received for sisal and sponge.

Phase 2 and 3: Growth and Decline

The factors explaining the growth in POSB depositors after the Second World War up until about the mid-1960s are several and various. The most important of these were, undoubtedly, the rapid growth in income resulting from the expansion in tourism and investment in this period, and the greater inclination on the part of the people to put their money in a bank as an alternative to hiding it. Another contributory factor was the limited spread of the commercial banks. As indicated in Chapter 3, the expansion of commercial banking in the Bahamas has largely been a post mid-'50s phenomenon.

TABLE 4.6

COMPARATIVE FIGURES RELATING TO DEPOSITS HELD BY THE POSB, THE ROYAL BANK OF CANADA AND THE BANK OF NASSAU, 1909 TO 1938

Year	POSB[a] £	Royal Bank of Canada[b] £	Bank of Nassau[c] £
1909	28,643	na	66,000
1913	26,201	67,888	70,874
1914	26,630	82,206	74,066
1915	23,833	82,057	61,256
1916	na	112,501	66,650[d]
1917	na	156,617	–
1918	na	183,455	–
1919	na	213,405	–
1920	na	471,602	–
1921	27,396	375,796	–
1922	na	742,709	–
1923	na	853,623	–
1933	57,312	568,175[c]	–
1938	na	979,609[c]	–

a: Year ending 30 June.

b: Year ending 31 March.

c: Year ending 30 November.

d: The Bank of Nassau was bought out by Royal in 1917.

Source: Colonial Office Reports.

As would be expected, the spread of branch banks in recent years has had a very adverse impact on the business of the Savings Bank. Since the early '60s, there has been a steady decline both in the number of depositors and in the number of deposits per annum, even though this has been a period of remarkable economic expansion in the Bahamas. The commercial banks with their higher interest rates and modern transaction facilities have succeeded in attracting not only the new income earners, but many of those who have traditionally patronised the POSB.

Tables 4.7 and 4.8 provide data on two aspects of this decline as reflected in the deposits position vis a vis the commercial banks, and in the increase in the number of closed and inactive accounts. It can be seen in the former table that, while in mid-1950 total deposits and savings deposits held by the commercial banking system amounted to $25.0 million and $4.4 million respectively, by mid-1978 these figures had increased to $253.2 million and $63.2 million respectively as compared to an increase in deposits held by the POSB from $1.0 million to $2,0 million over the same period. The result of this differential in the growth rates of deposits is that, whereas the outstanding savings held by the Post Office Bank in 1950 amounted to 4.3 per cent and 24.9 per cent of total deposits and savings deposits of the banking system respectively, by the middle of 1978 these proportions had dropped to 0.8 per cent and 3.3 per cent respectively.

That there has been a definite movement away from the use of the POSB as a savings facility there is no doubt. This is reflected to some extent in Table 4.8. At the middle of 1978, more than half of the total number of accounts on the books of the Bank was in the inactive category, some of which it might be noted, belong to people who are no longer alive. Though there are many reasons for this decline in popularity, some of which we have mentioned earlier, an important factor has no doubt been the relative inaccessibility of the POSB itself which has only seven offices in New Providence and Grand Bahama, as compared to more than 40 for the seven clearing banks, and these, moreover, are generally not located in the main thoroughfares.

Regulations Governing the POSB Assets Structure

The basic framework in which the Post Office Savings Bank was cast at its inception has changed little in substance over time. The Savings Bank Act of 1964 which forms the legal basis of the present day POSB mirrors, in essential respects, at least in so far as financial arrangements are concerned, the provisions of the 1936 Act which, itself, is in many ways an undiluted version of earlier legislations on which the Bank functioned. Such changes as have taken place have been minor, and can be described as largely administrative.

The financial regulations governing the operations of the POSB are reminiscent of those relating to the now defunct Currency Board System. The key stipulation is that relating to the disposition of the Bank's resources

TABLE 4.7

COMPARATIVE DEPOSITS FIGURES RELATING TO THE COMMERCIAL BANKS AND THE POST OFFICE SAVINGS BANK, 1950 AND 1973 TO 1978

	Commercial Banks		POSB		
Year Ending 30 June	(1) Total B$ Deposits $'000	(2) B$ Savings Deposits $'000	(3) Savings Deposits $'000	(4) (3) as a % of (1)	(5) (3) as a % of (2)
1950	25,007	4,374	1,089	4.3	24.9
1973[a]	152 300	43,700	2,286	1.5	5.0
1974	163,689	48,025	2,236	1.4	4.5
1975	187,925	49,335	2,158	1.1	4.4
1976	210,731	51,000	2,119	1.0	4.1
1977	237,220	56,173	2,060	0.9	3.7
1978	253,198	63,157	2,075	0.8	3.3

a. End of December

Source: Central Bank of the Bahamas and Table 4.5.

TABLE 4.8

POSB: INACTIVE ACCOUNTS[a] AS A PROPORTION OF TOTAL NUMBER OF ACCOUNTS, 1913 TO 1978

Year Ending 30 June	(1) Total Accounts	(2) Dead and Unclaimed Accounts	(3) (2) as a % of (1)
1913	2,361	495	21.0
1914	2,455	492	20.0
1915	2,434	584	24.0
1920	3,280	581	17.7
1922	2,673	634	17.3
1965	36,228	10,039	27.7
1974	34,934	19,058	54.5
1975	34,441	18,934	54.9
1976	34,556	18,793	54.4
1977	34,718	18,538	53.4
1978	34,632	18,310	52.8

a: Figures relating to these accounts in recent years are very rough estimates.

Source: Colonial Office Reports, *Annual Reports* of POSB.

which states that the

> *moneys in the Savings Bank shall not be applied in any way to the purposes of the Colony, but, except so far as any sums may be prescribed to be kept in hand for the general purposes of the Savings Bank, shall be deposited in the Treasury and shall, as far as practicable be invested on behalf of the Savings Bank, under the direction of the Treasurer, in such securities or be employed at interest in such manner as should be approved from time to time by the Governor, or in the case of moneys remitted to London for investment, by the Secretary of State, and any such investment may at any time be changed into other like securities.*

The flexibility implied in the last part of the sentence is qualified by the stipulation "that not more than one-third of such money shall at any time be or remain invested in securities of the Government of the Colony". [25]

In practice the funds of the POSB have been invested largely in securities of the United Kingdom and other Commonwealth countries. Until 1965 foreign investments generally accounted for over 90 per cent of the total assets of the POSB. Since then proportion has tended to decline, reaching 38 per cent in 1978. Part of the POSB investment now takes the form of Bahamian Government stock which (in mid-1978) accounted for roughly 40 per cent of total investments. The two other major components of the assets portfolio comprise an account with government and cash in bank, both of which taken together amount to about a quarter of total assets. It can be seen in Table 4.9 that despite the trend towards greater local retention of the POSB's resources, a significant part of the Bank's funds is apparently still invested abroad.

An Assessment

The Post Office Savings Bank was introduced into the Bahamas in the closing stages of the last century when the incentive for the setting up of conventional deposit banks was not particularly great. The motivation behind the conception of this institution is generally well known. The intention was to foster an attitude of thrift by providing a safe and convenient place at which small savers might store their savings. It was never intended that the POSB should compete with the profit oriented commercial institutions, and this is reflected in the fact that the basic rate of interest has changed little after almost a century of operations.[26] Further evidence in support of this contention is seen in the value limits placed on accounts and on the amount that can be deposited in any one year by a depositor.[27]

With the influx of foreign banks and with the growth of branch banking in the Bahamas, the POSB has lost a great deal of its importance. The higher interest rates paid by the commercial banks and the wider variety of services

TABLE 4.9

$'000 SELECTED FINANCES OF POST OFFICE SAVINGS BANK, 1958 TO 1978

Year Ending 30 June	(1) Market Value of Foreign Investments	(2) (1) as a % of (11)	(3) Account with Govt.	(4) Cash in Bank	(5) Cash in Hand	(6) Interest from Investments	(7) Interest Credited to Depositors	(8) Operating Expenses	(9) Amount credited to Reserve	(10) Total Reserve Account	(11) Total Assets/ Liabilities
1958	1,783	92.1	–	18	3	69	43	15	11	155	1,936
59	2,040	93.7	15	44	10	81	46	17	18	133	2,177
60	2,239	92.4	14	22	8	89	51	23	14	138	2,422
61	2,320	93.4	7	27	7	82	55	22	5	135	2,485
62	2,213	95.4	12	21	2	106	54	22	30	130	2,320
63	2,271	98.4	22	15	1	104	52	23	29	131	2,308
64	2,239	95.1	25	87	3	103	52	22	29	86	2,354
65	2,183	90.4	38	165	30	105	53	26	26	89	2,415
66	2,173	87.4	140	191	5	110	55	27	28	97	2,509
67	1,990	78.3	258	259	15	105	58	29	19	134	2,541
68	1,933	75.0	329	256	3	110	59	31	20	352	2,577
69	1,890	69.2	405	291	65	116	61	34	20	369	2,729
70	1,692	61.4	468	397	40	105	64	37	4	433	2,755
71	1,917	72.7	627	279	1	230	62	46	121	429	2,636
72	1,879	78.1	195	498	8	133	59	50	24	119	2,406
73	1,602	70.0	270	353	6	147	50	51	46	103	2,288
74	1,353	60.5	353	246	13	128	52	53	23	306	2,237
75	1,729	75.7	246	305	12	139	52	54	33	659	2,285
76	1,554	57.7	317	236	11	154	49	57	48	175	2,694
77	971	47.1	397	153	4	155	49	59	47	73	2,062
78	798	384	415	131	5	93	48	64	18	204	2,076

Sources: Post Office Savings Bank, *Annual Reports;* Central Bank of the Bahamas, *Quarterly Review,* various issues.

offered, have rendered the Post Office Bank almost obsolete. We say almost because in some of the sparsely populated islands the latter is still the only bank available. This situation, however, should not detract from the need for a fundamental re-structuring of its operations along lines consistent with the objectives which the Government has set itself. In its Independence White Paper of October 1972, the Government pledged itself to convert the Bank into a National Savings Bank. Exactly what is entailed here is not quite clear. However, if the intention is to set up a bank that can compete with the private institutions on an equal footing, then there is certainly merit in the idea. Within such a framework not only would it be possible to extend commercial banking activities to areas not at present in receipt of such services, but of even greater importance is the opportunity that would be created for influencing domestic credit policies, and for diverting at least some part of the local resources generated to sections of the community, who for various reasons have not been able to satisfy the lending criteria demanded by the private banks.

Laudable as the latter objective may seem, however, the experience of other Commonwealth Caribbean countries with national banks is worth bearing in mind. The establishment of local banks in some of these states has not generally resulted in any radical departure from traditional banking policies and practices to which frequent and vociferous exception has often been taken. Part of the explanation for this no doubt stems from the local conception of expatriate institutions which are generally viewed as being of a sounder nature than their local counterparts which are yet to prove themselves. In the Bahamas, the problem is greatly compounded by the overwhelming domination of the financial sector by overseas banks and their ubiquitous presence in a country consisting of a little over 220,000 people.

THE PEOPLE'S PENNY SAVINGS BANK (PPSB)

This institution has the distinction of being the only locally owned bank in the Bahamas. Its inception in 1952 was prompted to a large degree by the lending policies of the two banks then in existence, which found it much easier to export their funds for use abroad, than to employ them locally. Its entire outlook, since, has been fashioned by the desire to perform a social role by providing finance in areas which have generally been shunned by the ordinary commercial banks which, as is well known, normally tend to concentrate the major part of their resources on short term lending involving minimum risks and a quick return. This role, however, has never been properly articulated, and, in fact, has been at variance with the structure of the institution which has remained static in the face of a rapidly changing environment.

Assets Structure

Total assets of the PPSB grew from $0.6 million in 1960 to $2.4 million in 1979. This represents an average growth rate of 7.6 per annum in current dollars. In real terms there has been very little growth.

Table 4.10 shows the main areas in which the bank has been concentrating its resources since 1960. By becoming involved in such activities as mortgage lending and housing development (the first low cost housing project in the Bahamas, though a modest one, was initiated and carried out by the bank), the PPSB has in the course of time acquired a highly illiquid portfolio which is somewhat peculiar for an institution of this kind. Short term loans have generally accounted for less than 15 per cent of total assets. Mortgage loans and long term investment on the other hand have, in recent years, been contributing over 30 per cent to total assets. Figures relating to real estate and housing development are not readily available and it is therefore difficult to make any statements on the relative positions of these assets in the total picture.

With respect to the relationship between certain assets and deposits, Table 4.11 gives some indication of trends in recent years. The cash ratio seems to have dropped drastically since the early '70s. The proportion for short term loans is generally less than 20 per cent while that for mortgages has exceeded 30 per cent in recent times. With respect to the other avenues, the absence of data again does not allow us to make any sound observations.

Liabilities Structure

The PPSB draws its funds from two sources, viz. share capital and deposits both of which have grown over the years. The relative contributions at the end of each financial year are presented in Table 4.12 which shows that, on average, deposits account for over 90 per cent of total resources of the bank.

Before going on to discuss the deposit facilities offered by the PPSB, it is appropriate to say a word on the adequacy of the capital resources on which the bank has operated over the years. while it is clear that shareholders' funds have not been of a magnitude that could safely support the kind of activities in which the bank became involved, there is a great deal of controversy, as we have indicated in an earlier chapter, as to what criteria should be used in assessing the adequacy of bank capital. One yardstick used some years ago by the United States' Federal Deposit Insurance Corporation (FDIC) was a relationship between capital stock and deposits, which it thought should be in a ratio of approximately $25,000: 1 million, or 1:40. in other words, for every $1 million of deposits, a bank needed to have capital funds of $25,000 to be on the safe side. This test was later abandoned in favour of a capital/assets ratio which is thought to be a better measure since losses are experienced on assets rather than on liabilities. Out of this concept has grown such refinements as the 'capital funds to risk assets ratio and the 'capital to loan' ratio. Risk assets in this context are often defined as total assets less cash and government securities.

Whatever the aggregate chosen by the supervisory authorities to de-

TABLE 4.10

SELECTED ASSETS OF PEOPLE'S PENNY SAVINGS BANK AS A % OF TOTAL ASSETS, 1960 TO 1979

Year Ending 30 Nov.	(1) Total Assets $'000	(2) Short Term Loans $'000	(3) (2) as a % of (1)	(4) Mortgages $'000	(5) (4) as a % of (1)	(6) Housing Develop-ment $'000	(7) (6) as a % of (1)	(8) Real Estate (at cost) $'000	(9) (8) as a % of (1)	(10) Total Selected Assets as a % of Total Assets
1960	584	72	12.3	71	12.1	90	15.4	169	28.9	68.7
1961	623	83	13.3	80	12.8	87	14.0	170	27.3	67.4
1964	781	87	11.1	87	11.1	140	17.9	170	21.8	61.9
1965	1,016	116	11.4	149	14.7	226	22.2	170	16.7	65.3
1966	1,285	185	14.4	222	17.3	234	18.2	170	13.2	63.1
1967	1,590	213	13.4	303	19.0	234	14.7	139	8.7	55.8
1968	1,885	213	11.3	508	26.9	281	14.9	138	7.3	60.4
1969	2,290	335	14.6	908	39.6	b	b	190	8.3	62.5
1970	2,196	308	14.0	1,000	45.5	b	b	167	7.6	67.1
1971[a]	2,549	252	9.9	927	36.4	b	b	na	na	na
1972	1,490	128	8.6	567	38.0	b	b	185	12.4	59.0
1973[c]	1,887	222	11.8	560	29.7	b	b	na	na	na
1974	1,635	229	14.0	614	37.5	b	b	b	na	na
1975[d]	1,901	219	11.5	586	30.8	b	b	na	na	na
1979[e]	2,394	306	12.8	752	31.4	b	b	na	na	na

a: At 31/5/71.
b: Included in mortgages.
c: At year end.
d: At 31/10/75.
e: At 30/3/79.
Sources: People's Penny Savings Bank and Central Bank of the Bahamas.

TABLE 4.11

SELECTED ASSETS OF THE PEOPLE'S PENNY SAVINGS BANK AS A % OF TOTAL DEPOSITS, 1960 TO 1979

Year Ending 30 Nov.	(1) Cash in Hand and in Bank	(2) Short Term Loans	(3) Mortgages	(4) Housing Development	(5) Real Estate
1960	18.6	17.5	17.3	21.8	41.3
1961	20.8	18.6	17.9	19.3	37.7
1964	16.0	13.2	13.2	21.3	25.8
1965	19.6	13.0	9.8	15.8	19.1
1966	18.4	15.6	18.7	19.7	14.3
1967	21.6	14.3	20.4	15.8	9.4
1968	19.7	12.2	29.0	16.0	7.9
1969	12.2	14.6	39.7	a	8.3
1970	10.0	21.6	41.2	a	11.7
1971[b]	10.4	11.0	40.5	a	na
1972	na	5.6	25.2	a	8.2
1973	3.0	11.2	28.2	a	na
1974[c]	1.1	13.2	35.4	a	na
1975[d]	1.3	13.3	35.6	a	na
1979[e]	4.9	16.2	39.7	a	na

a: Included in mortgages.
b: At 30/5/71.
c: At year end.
d: At 31/10/75.
e: At 30/3/79.

Sources: People's Penny Savings Bank and Central Bank of the Bahamas.

termine the solvency of banks, one thing is clear and it is that the ratio would tend to vary from one environment to another in response to a host of different factors. A glance at column 4 of Table 4.12 shows that the proportion of capital funds to its total assets for the PPSB seems to have been increasing over time. This, however, has, no doubt, probably been due more to the slow growth in deposits (and assets) and the need to meet maturing commitments, with which assets were not properly matched, rather than to any deliberate attempt on the part of the shareholders to put the bank on a sounder footing or to accelerate its growth.

Traditionally, the People's Penny Savings Bank, as the name implies,

TABLE 4.12

PEOPLE'S PENNY SAVINGS BANK: SOURCES OF FUNDS, 1960 TO 1979

Year Ending 30 Nov.	(1) Deposits %	(2) Share Capital %	(3) (1) + (2) %	(4) Ratio of Share Capital to Total Assets
1960	93.7	6.3	100.0	4.7
1961	93.3	6.7	100.0	5.1
1964	94.8	5.2	100.0	4.6
1965	95.6	4.4	100.0	4.0
1966	96.3	3.7	100.0	3.5
1967	95.2	4.8	100.0	4.7
1968	94.8	5.2	100.0	5.1
1969	94.8	5.2	100.0	5.5
1970	94.4	5.6	100.0	6.6
1971[a]	94.0	6.0	100.0	5.7
1972	93.2	6.8	100.0	11.1
1973[b]	92.2	7.8	100.0	8.8
1974	91.2	8.8	100.0	11.7
1975	90.7	9.3	100.0	8.8
1979	91.9	8.1	100.0	7.0

a: At 31/5/71.
b: Year ending 30 December.
Sources: People's Penny Savings Bank; Returns to Central Bank of the Bahamas.

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has not offered chequeing accounts facilities, though as we shall see later, commercial banking functions are likely to become an integral part of its operations as the bank is transformed into a new organisation. Currently, deposits are categorised into four groups shown in Table 4.13 viz. fixed, regular, guarantee and 'other'. The fixed accounts are time deposits made for 6 months and 1 year periods, on which rates of 7 to 8 per cent are currently being paid. The lower rate is paid on deposits of between $500 and $3,000 while the higher rate is associated with deposits over $3,000. Regular savings accounts are similar to those operated by the commercial banks both in terms of interest paid and administration. While under the rules a withdrawal notice is required, in practice, payments are generally made on demand.

Guarantee savings refer to an arrangement under which depositors agree to pay into an account a fixed sum on a weekly basis for a period of 10 years, during which time no withdrawals are allowed. Interest is payable on these deposits at a guaranteed rate calculated on a sliding scale formula which has been worked out by the bank. In the event of a withdrawal before maturity, normal interest is paid to the depositor. The 'other' category is comprised mainly of two schemes which the bank has promoted with some success. These are the Christmas Club and the Vacation Savings plans, under which deposits can be made at any time and in any amount. No interest is, however, payable on savings made under these plans. As the name implies, these are special accounts which an individual might wish to keep separate from his or her regular savings in order to meet expenditure connected with the Christmas season, or vacation plans which can coincide with any period of the year. Based on this rationalisation, withdrawals under the vacation plan can be made at any time.

A look at Table 4.13 shows that in recent years, regular savings deposits have accounted for over three quarters of the bank's total deposits, while the bulk of the remaining proportion has been contributed by the fixed accounts. As for other facilities, both the vacation and guarantee plans are no longer actively promoted, and this comes out to some extent in the table. With the maturation of some of these deposits, and the inability to attract new depositors, total deposits have shown a tendency to decline in recent years. This has contributed immensely to the awkwardness in which the bank finds itself, given the type of assets in which its funds are tied up.

An Assessment

Even though the deposits of the PPSB have grown over the last decade, the bank has clearly not experienced the expansion of the more commercially oriented institutions which offer a broader range of services and are better equipped, staffwise, to deal with the varied demands made upon them. It is surprising, to say the least, that the Penny Savings Bank with its existing structure and orientation has been able to survive at all in a financial environment of the kind prevailing in the Bahamas, which has grown increasingly sophisticated over the past two decades.

If the bank is to attract a greater share of the local business there is need for both a change in outlook and a fundamental re-organisation of the entire operation. Traditionally, it has seen itself catering mainly to the small saver who in recent years has not only become exposed to a wider range of savings facilities, but has also, undoubtedly, become more safety and income conscious. The close-down scares of some years ago and the consequent run on the bank have not helped matters. To get itself in the mainstream of the business,[28] the bank has not only to institute the full

TABLE 4.13

PEOPLE'S PENNY SAVINGS BANK: SAVINGS DEPOSITS BY TYPE, 1960 TO 1979

Year Ending 30 Nov.	(1) Fixed $	(2) (1) as a % of (9)	(3) Regular $	(4) (3) as a % of (9)	(5) Guarantee $	(6) (5) as a % of (9)	(7) Other $	(8) (7) as a % of (9)	(9) Total
1960	na	na	na	na	na	na	na	na	410 162
1969	74,516	3.2	2,167,145	94.7	27,036	1.2	21,574	0.9	2,290,271
1970	102,642	4.2	2,285,393	94.3	15,276	0.6	22,031	0.9	2,425,342
1971[a]	301,193	13.1	1,961,376	85.8	10,769	0.5	12,994	0.6	2,286,332
1972	413,280	18.3	1,812,160	80.4	9,276	0.4	18,107	0.8	2,252,823
1973[b]	e	—	1,985,000	—	e	—	e	—	1,985,000
1974[b]	e	—	1,735,000	—	e	—	e	—	1,735,000
1975[c]	e	—	1,296,000	—	e	—	e	—	1,296,000
1978[c]	e	—	1,400,944	—	e	—	e	—	1,400,944
1979[d]	e	—	1,807,255	—	e	—	e	—	1,807,255

a: At 31/5/71.

b. End of December.

c: End of October.

d. End of February.

e. Included in regular.

Source: Returns to Central Bank of the Bahamas.

range of services associated with modern day commercial banking within a more strategic and wider location network,[29] but would have to show itself capable of handling the resources at its disposal. To do this, a necessary requirement is certainly the recruitment of a highly trained staff with the ability and the freedom to manage the portfolio of the bank in a manner more compatible with its liabilities structure, and which could achieve, for the bank, a degree of efficiency that could generate the kind of confidence so essential for the functioning of any financial institution, particularly in such a competitive environment.

The Future

On September 25, 1974, the Government announced that it had decided to take over the Penny Savings Bank which, together with the Post Office Savings Bank would form the basis of the National Savings Bank mentioned in the Independence White Paper. In a House communication, the Prime Minister, Mr. Lynden Pindling, stated that the decision had come about as a result of a request made by the Directors of the bank, who felt that their skill and expertise could no longer match the bank's rapid growth. The Prime Minister added that because of the high priority accorded Bahamians in the middle and lower income bracket in Government's planning, the latter could not ignore the request to step in and save the bank, since the welfare of 21,000 'grass-root' Bahamian depositors was tied to the bank's future. He further added that Government's action was not only motivated by the bank's 'impressive record of social service' but by the fact that the aims of the PPSB were also in accord with the government's policies on the encouragement of savings and the mobilisation of capital for economic and social development.

Commenting on the bank's transition to Government ownership, Mr. Pindling stated that the Directors (including Government Ministers who owned shares in the institution) had decided to assign to Government, without consideration all their shares. The bank, would continue to serve its customers as before, but in due course there would be new management and then it, and the Post Office Savings Bank representing between them 55,000[30] savings accounts, would be made the basis of the National Savings Bank.

In the final part of our discussion on the Post Office Savings Bank, we mentioned some of the difficulties that are likely to be faced by small local institutions venturing into a field long dominated by foreign enterprises, and there is therefore no need to repeat these at this point. Since, however, Government's take-over of the PPSB seemed to have generated some uneasiness in certain quarters, we think it necessary to make a few further comments, particularly as they relate to local attitudes and perspectives to which we have drawn attention at several points in the study.

Commenting on the take-over of the PPSB by Government, one local political party charged that this action "will have an adverse effect on commercial banking in this country".[31] While this may be an isolated view, what is certain is that there is yet to emerge a widespread appreciation of the role of financial resources in the process of economic development and the significance of financial institutions in this context. Too often are financial institutions viewed as ends in themselves, merely providing a service to the individual or corporation as a savings repository or financier, rather than as a critical mechanism in the broader task of mobilising and channelling resources in particular directions with a view to transforming the economy and raising the standard of living of the general population. If local institutions are to make any headway in the domestic banking business, there is need for a wider appreciation of this perspective, from which the long term implications of present policies being pursued by the foreign banks could more easily be discerned and perhaps affected. This is all the more urgent since it appears that the lending attitudes of the banks, at present, are a factor discouraging savings. This is reflected in the often expressed preference for spending as against the accumulation of funds in institutions from which accommodation is difficult to obtain when required, even for productive purposes. The situation at the moment, it seems, would appear to demand that Government lifts its banking horizon beyond the existing depositors of the PPSB and the POSB who together hold, as we saw earlier, about 3 to 4 million dollars or less than 2 per cent of the total deposits held by the commercial banks.

There is no doubt that the public needs to be better educated on the importance of savings to the future of the country if a greater effort is to be made in curtailing conspicuous spending which has become a prominent trait of Bahamian society. At the same time, however, it is necessary to create a framework in which Bahamians are not precluded from access to locally generated resources by irrelevant policies and practices that bear little relationship to the reality of local conditions and to the imperatives of the social situation, which the Government could afford to ignore only at its own peril. If in this exercise it is seen fit to create locally owned institutions which might influence traditional attitudes and, thus, contribute to the resolution of some of the pressing problems facing the country, then there seems to be no valid reason why this should not be done, though it is well recognised that there are many people who think that banking is some sort of esoteric science on which foreign enterprises have a monopoly and the Government and local people should therefore steer clear of this area.[32]

On the question of Government ownership, it is well known that such a policy often becomes necessary in the absence of private initiative, or where the area concerned is too important from a social point of view to be left in private hands. There is nothing wrong with Government ownership as such, particularly in a development context where intervention in the form of ownership or control often becomes necessary in order to correct anomalous situations having critical social or economic implications. What must be guarded against, however, is the total disregard of efficiency, and the intrusion of sinister political interference which could affect the proper functioning of the institution, thus destroying any attempt to stimulate public confidence in its operations. Organisations dependent for survival on the voluntary patronage of the public in a competitive situation just cannot afford to be run like a civil service department.

Finally, we might note that the take-over of the Penny Bank and the proposed reorganisation of the POSB presents the Government with an ideal opportunity for some financial innovation with the object of increasing the social and economic value of the financial system. One undertaking which could easily be incorporated within the framework of the National Savings Bank is the institution of a payments system based on the Giro idea operating in Japan and several European and African countries. While the major purpose underlying the Giro facility is to provide an economical, efficient and secure means of payment for people who do not own a current bank account, there are many advantages to business firms and utility companies, particularly in the collection aspect of their operations. Some of the services with a Giro makes possible can be gleaned from the British system which is structured to provide the following facilities.[33]

(i) transfer from one Giro account to another;

(ii) for personal customers withdrawal of cash up to a stated sum every other working day at either of two nominated post offices. (The Giro operates through the post office network);

(iii) payments into Giro accounts by persons without an account;

(iv) payments by account holders in Giro to persons who do not have a Giro account

All accounts are maintained at a central station, and debits and credits are made instantly (through computer) upon instructions, thus avoiding the long delays involved when transactions are made through a system that is based on periodical clearing. Against this advantage, one feature of the Giro as it operated in Britain, and which has, no doubt, contributed to its less than optimum use, is the fact that it did not at one time offer overdraft facilities as is the case with current accounts in the commercial banks with which the system competes.[34] Even without this facility, however, there is much to recommend a Giro in a situation where a large number of people are not within reach of a bank, or who for one reason or another do not operate a chequeing account.

In conclusion, it should be stated that whatever form the new Savings Bank takes, an important feature of that structure must be the availability of its resources to the people who use its facilities. The kind of arrangement associated with the POSB, which requires the savings placed with this institution to be put at the disposal of foreign governments, can no longer be considered tenable in present day circumstances.

THE TRUST COMPANIES[35]

As the name implies, the primary activity of these companies is to act in a trust of fiduciary capacity both for local and overseas clients, the latter, however, providing the bulk of their business which in one way or another tends to be related to the desire by individuals and corporations to avoid certain fiscal measures[36] in the country of normal residence. In this context, trust companies rank among the most significant institutions not only in the Bahamas, but in a number of other 'offshore' centres which operate tax systems with a view to attracting such business.

In this section, we outline some of the main services offered, and, later, from the statistics available, try to evaluate their impact on the domestic financial system. Firstly, however, we should say something about the organisation of the trust sector.

At the end of 1978, there were some 89 institutions (excluding 33 nominees and four non-active) licensed to do trust work arising in or from outside the Bahamas. Of this number, 32 could transact business only with a restricted clientele, while 57 were authorised to deal with the public at large (See Table 2.2). Included in these figures were five commercial banks which hold a bank and trust licence. Most of the institutions doing trust work in fact operate on the basis of this type of licence. For exchange control purposes, only 20 of the 89 licensees had 'resident' status, i.e. the authority to do Bahamian dollar business. As far as ownership is concerned, the entire trust sector is foreign owned and controlled. Some business is transacted through departments of the commercial banks, but the bulk accrues to separate entities set up specifically to do trust work.

The services provided by trust companies are wide-ranging in character. For our purposes, however, it would be sufficient to mention some of the major ones which are given prominence in their annual reports, and other advertising pamphlets on which the following summary is based.

Banking Services

As indicated earlier, some trust companies have licences that permit them to engage in activities of both a trustee and banking nature. As will be seen later, however, while a small amount of Bahamian dollar business is done, the bulk of their banking operations is related to the acceptance of current and time accounts in foreign currency which are normally on-lent or re-deposited without conversion into the local medium.

Trust Administration

This area of the tax haven business, undoubtedly, generates a good deal of the trust companies' income. A Bahamian trust (i.e. a trust subject to Bahamian laws) can be created by a resident of any country in the world, and for reasons that will be discussed later, a Bahamas trust is a very useful and convenient device for holding property of various kinds in the context of long term estate planning.

It has been stated that besides the security and management expertise which a corporate trustee provides, an added advantage over the use of an individual as trustee (such as a lawyer or an accountant) is that the former can provide continuity in administration. For example, when a managed company is set up in the Bahamas and the shares are put in trust, on the death of the beneficial owner(s) it is the shares of the company that pass on, not the assets of the company. In such a case, there is no need for a Will which only becomes necessary where the shares are not held in trust.

Company Management Service

A managed company[37] like a self-operating entity, is formed under the Companies Act which is modelled on the United Kingdom Act of 1862.[38] The law, which has undergone little change, requires that a company limited by shares must have at least five shareholders[39] on whom it imposes no restrictions in terms of residence or nationality.[40] It also requires that all companies formed in the Bahamas must have a Registered Office in the country, the place of location being indicated by a sign.[41] Besides these, there are a number of other requirements such as the once yearly meetings of shareholders and the annual filing of returns containing certain information relating to shareholders, shares outstanding etc. with the Registry.

A Bahamian-managed company, which can be formed[42] both by individuals and corporations, is used in a variety of ways, all calculated to maximising after-tax income. For example, an individual in a high earnings area like sports or entertainment can use such a device to divert part of his income in an effort to reduce his tax liability in his home country. "A managed company may also act as a buffer between the client and his country of residence for tax purposes equalising his tax liability through the prudent declaration of dividends and other remittances'[43] For multinational corporations, the uses to which a Bahamian managed company can be put are even more varied and financially rewarding. Besides the well-known technique of exporting companies selling through a tax haven subsidiary, thus allowing profits to accumulate in a tax free area, a Bahamian company "can acquire from the owner the right to develop and exploit the use of patent rights and to sub-licence such rights or provide technical assistance to third parties throughout the world".[44] The device can also be used to reduce the cost and risks of intra-group borrowing activities by setting up a managed company in a fronting capacity.[45]

Trust companies provide the whole range of services necessary for the existence and functioning of a managed company in the Bahamas. These include provision of a registered office, company officers, directors and nominee shareholders as well as the preparation of accounting and financial reports. The filing of statutory returns with the local authorities, the holding of the Annual General Meeting and the preparation of the Minutes are also part of the services offered by these institutions.

Management of Banks

Investors and other holders of wealth may wish to set up their own banks with limited objectives and related to the particular needs of their creators. In the context of their Euro-currency operations, many foreign financial institutions have also found it necessary to set up limited service branches in Nassau in order to exploit the advantages which such concerns offer in the context of their international activities.

Escrow Services

Trust Companies can act as 'escrow agent' or 'stakeholder' in regard to property transactions and can also assist in the drafting of escrow agreements.

Other Services

These include investment management (independently or on instructions), custodian trustee of funds managed by someone else, and trust facilities for pension funds of multinational companies. Some institutions also offer services relating to offshore mutual funds and unit trusts, while also acting in the capacity of local managers for partnerships and company registrar and transfer agent.

As far as the income of trust companies is concerned, this is derived from sources like interests, dividends, returns from investment and service charges.[46] The relative importance of the items varies from company to company, but, generally, they are the same for most operators.

The Balance Sheet of Trust Companies

An accounting convention followed in the Bahamas (as in several other countries) is that the balance sheet of a trust firm normally does not include funds under administration or held in a fiduciary capacity,[47] even though in the case of a trust, ownership is legally vested in the trustee with complete authority over the assets. The published assets and liabilities of the companies tend to relate essentially to the banking aspects of their business to which reference was made earlier. In view of this practice, it has to be concluded that the balance sheet figures do not give a fair indication of the total amount of business undertaken by these concerns.

As indicated earlier, the business of trust companies is largely of an external nature, their presence in the Bahamas being motivated principally by the tax and administrative arrangements of the country. There are, however, five [48] resident companies whose operations involve a limited amount of domestic activity. The combined balance sheet of these companies at the end of 1973 and 1978 is presented in Tables 4.14 and 4.15. It can be seen from the figures shown there that local business appears to form a small part of the total operations of the trust firms. At the end of 1978 B$ assets amounted to less than 2 per cent of total assets. Another feature to note, and one which perhaps is not readily apparent from the two periods shown in the table, is the fact that the total assets of the companies fluctuate

TABLE 4.14

ASSETS COMPOSITION OF TRUST COMPANIES[a], 1973 AND 1978

$'000 Assets	1973 (end) Payable in B$	1973 (end) Payable in Foreign Currency	1973 (end) Total Assets	1978 (end) Payable in B$	1978 (end) Payable in Foreign Currency	1978 (end) Total Assets
1. Notes & Coin in Hand: B$	–	–	–	2	–	2
Foreign Currency	–	–	–	–	–	–
2. Balance with Central Bank	–	–	–	13	–	13
3. Balance with Financial Institutions in Bahamas						
(a) Sight	381	82,556	82,937	685	1,108	1,793
(b) Fixed	2,053	279	2,332	427	14,789	15,216
(c) Loans	–	22,758	22,758	–	4,261	4,261
4. Balance with Offshore Financial Insititutions in Bahamas	–	500	500	–	169,445	169,445
5. Due from Financial Institutions Outside the Bahamas:						
(a) Head Office	–	18.013	18,013	–	22,261	22,261
(b) Other	–	20,937	20,937	–	32,225	32,225
6. Mortgage Loans.						
(a) Local	2,006	415	2,421	537	479	1,016
(b) Non-Local	–	–	–	–	–	–
7. Other Loans & Advances:						
(a) Local	420	38,040	38,460	479	–	479
(b) Non-Local	157	107,551	107,708	–	46,341	46,341
8. Claims on Government:						
(a) Treasury Bills	–	–	–	–	–	–
(b) Other Securities	551	160	711	959	513	1,472
9. Investment in Stocks & Shares:						
(a) Local Securities	1,080	34	1,114	2	1,975	1,977
(b) Foreign Securities	–	3,865	3,865	–	2,999	2,999
10. Premiums & Other Fixed Assets	655	2,971	3,626	278	2,581	2,859
11. Other Assets	1,076	5,308	6,384	1,884	4,411	6,295
Total Assets	**8,379**	**303,387**	**311,766**	**5,266**	**303,388**	**308,654**

a Five firms which undertake some degree of Bahamian dollar business.

Source: Central Bank of the Bahamas.

TABLE 4.15

LIABILITIES COMPOSITION OF TRUST COMPANIES[a], 1973 AND 1978

$'000

Liabilities	1973 (end) Payable in B$	1973 (end) Payable in Foreign Currency	1973 (end) Total Assets	1978 (end) Payable in B$	1978 (end) Payable in Foreign Currency	1978 (end) Total Assets
1. Deposits						
(a) Demand	91	–	91	19	829	848
(b) Fixed & Savings	138	26,544	26,682	22	1,286	1,308
(c) Non-Local	128	159,662	159,790	213	246,458	246,671
2. Due to Financial Institutions in Bahamas:						
(a) Sight	–	358	358	213	5	218
(b) Fixed	–	–	–	–	26,879	26,879
(c) Borrowings	–	82,063	82,063	–	–	–
3. Due to Offshore Financial Institutions In Bahamas	–	–	–	–	212	212
4. Due to Financial Institutions Outside the Bahamas Head Office	–	–	–	–	5,551	5,551
Other	–	17,620	17,620	4,436	4,436	4,436
5. Capital and Reserves	12,549	3,218	15,767	11,801	5,029	16,830
6. Other Liabilities	1,125	5,954	7,079	1,821	3,417	5,238
Total Liabilities	**14,031**	**295,419**	**309,450**	**14,089**	**294,102**	**308,191**

a: Five firms which undertake some degree of Bahamian dollar business.

Source Central Bank of the Bahamas.

widely from one period to another. The main factor appears to be the level of banking business undertaken.

An examination of Tables 4.14 and 4.15 shows that at the end of the two years represented there, the totals of the B$ assets columns were greater than the comparable figures on the liabilities side. This gives the impression that a portion of the paid-up capital (and perhaps reserves), has been converted into foreign currency and put to use either in the Bahamas or outside the country. Since such a transaction is likely to encounter exchange control difficulties, it is possible that the situation reflected in the tables may be nothing more than the outcome of bad reporting, the capital (or most of it) having been paid up in foreign currency. Whether the latter is the case or not, it is worth pointing out that the submission of statistics to the authorities by financial institutions often lacks the expected level of consistency and this can easily give rise to a variety of interpretations of particular situations.

Bearing this in mind, it is still possible to make a number of valid observations about the operation of these trust companies on the basis of Table 4.14 and 4.15. Firstly it should be pointed out, as was done above, that the figures in these tables relate only to companies which do both local and foreign business, and, therefore, do not reflect the transactions of entities engaged exclusively in the latter area. Looking at the Bahamian dollar column of the liabilities side of the balance sheet the dominant items are the shareholders' accounts viz. capital and reserves which account for over 75 per cent of total B$ liabilities. From the table, it appears that some amount of domestic banking is done, though, at the moment, the scale of such activities is at a very insignificant level.

On the assets side, the distribution between items seems to be more widely dispersed indicating (perhaps) a lack of preference for any particular type of investment, at least among the outlets available. Deposits, mortgage loans and local securities appear to be the items of most interest.

With respect to the foreign currency operations of these companies, it can be observed that a significant part of it is conducted in the Bahamas, in some cases with related institutions engaged in banking and finance activities. The nature and purpose of these inter-firm transactions are not quite clear. The factors which appear to affect such dealings most relate to the desire to provide certain types of services to clients and to the need to effect financial strategies designed to enhance the operational flexibility of the group structure.

THE BAHAMAS DEVELOPMENT BANK (BDB)

For various reasons we have touched upon in an earlier chapter, commercial banks generally confine their lending activities to the making of short term commercial loans. Even where medium and long term financing is provided, such facilities are "normally available only to enterprises which have already established a good credit rating or to old customers who cannot be refused, or who have ample collateral security. The newer concerns, the businessman without substantial backing, will generally find difficulty in obtaining proper finance".[49] Given this situation, the need for an institution to provide long term funds in areas which are not generally attractive to conventional commercial operations, was recognised several years ago, and in its Independence White Paper of 1972, the Government firmly pledged itself to the establishment of a Development Bank, whose main purpose was seen as that of raising funds and investing them "as capital finance for commerce and industry, the investment decision being made on the prospects of the business rather than on the amount of collateral".[50] Such a bank was also viewed as necessary to the success of the cooperative societies which the Government decided should be founded on a legal basis. Not until September of 1974, however, was the legislation setting up the Bahamas Development Bank (BDB) brought to Parliament for its approval. Since at the time of writing the bank had been in operation for only a short period (just over one year), in the following section we shall focus our attention on the main provisions of the BDB Act as they relate to structure and functions of the instituion, and briefly discuss the implications of particular banking perspectives in a development context.

The BDB was established as a body corporate having perpetual succession and a common seal with the power to acquire, hold and dispose of property and to enter into any contract necessary to the carrying out of its functions. It can sue and be sued in its corporate name.

The policy of the bank and its general administration is entrusted to a Board of Directors, which is to comprise a Chairman ("who shall be a person having in the opinion of the Minister [of Finance] considerable knowledge and experience of banking and financial matters") and not less than six other directors of whom one is to be the managing director. Like the chairman, the other five are to be appointed by the Minister of Finance on the basis of their knowledge and experience of the Bahamian economy.

As to where the responsibility for determination of policy and orientation of the Bank rests, the law is quite explicit. Section 9 (1) states that the "Minister [of Finance] may, after consultation with the Chairman, give to the Bank such directions in writing as to the policy to be followed by the Bank in performance of its functions as appear to the Minister to be requisite in the public interest, and the Bank shall give effect to any such directions".

Because of varying perceptions of what constitutes an adequate level of capital for a development bank, one finds great differences in the capitalisation of such institutions in the various countries. It is also common to find differences in the structure of ownership. Some organisations, for example, even permit individuals to become shareholders, while others confine membership solely to government or government-owned organisations and private institutions. Lending policies also vary widely. Some banks lend only to privately owned enterprises, while some others provide assistance even in cases where government has a minority or even a controlling interest. Again while certain institutions are authorised to provide resources for social purposes (e.g. housing development), the concern of others is more narrowly defined. In general, development banks tend to be given structures and orientation which take into account the peculiar conditions existing in the areas where they are created and in the context of which they have to function as mechanisms instigating economic and social change.

The authorised capital of the bank is five million dollars, and this is divided into one million shares of par value of five dollars each.[51] The capital can, from time to time, be increased by resolution of the Board. From pronouncements [52] made in the past it seems that ownership will be shared between the Government, the Central Bank, private banks and insurance companies. From the wording of Section 22 (1) of the Act, it appears that the Government (and its agencies) will normally hold a minimum of 75 per cent of the common shares of the bank which is forbidden from selling, distributing or in any way disposing of more then 25 per cent of its own voting stock (or that of any subsidiary it may own) without the approval of the House of Assembly. Whatever the level of participation by private shareholders within this limit, one thing seems clear in the light of what we have said earlier, and it is that these shareholders will have little say in the direction and operations of the bank. However, if their cooperation is voluntary, the bank will no doubt have to satisfy certain conditions to attract any funds from them. This may involve guaranteeing a minimum level of return on invested funds, a condition that may result in an operational orientation that could be deemed to be in conflict with the basic objectives of the bank which is not intended to be a purely commercial institution.[53] If the main criterion governing lending turns out to be the level of return, then the whole purpose of the institution would have been lost, as we shall see later.

The resources of the bank are not confined to its share capital. The BDB is permitted to borrow both from private and public sources (locally and abroad) in the form of loans, debentures or bonds. To enhance the borrowing capabilities of the institution, the Minister of Finance is authorised, with prior approval of the House of Assembly, to guarantee ("in such manner and on such conditions as he may think fit") the payment of the principal and of interest on any authorised borrowings of the bank. In the event of default on such loans by the bank, repayment is to be made from the Consolidated Fund.

In order to build up a reserve fund to meet contingencies and other similar purposes, the bank is required to set aside each year a minimum of 25 per cent of its net profit (if any) until the amount standing to the credit of this fund is equal to its paid up capital.

The BDB is not permitted to engage in unlimited borrowing. Section 15 (2) of the Act states that the "aggregate of the liabilities of the Bank, outstanding at any one time including direct liabilities such as bonds and debentures issued by the Bank and the contingent liabilities of the Bank in the form of guarantees given, or under-writing agreements entered into by it, shall not at any time exceed seven times the aggregate amount of paid up capital and the reserve fund. . .".

The main functions of the BDB are very broad and are set out in Section 4 in the legislation, as follows:

(a) to promote industrial, agricultural and commercial development in the Bahamas through the financing of, or the investing in approved enterprises; [54]

(b) to encourage the participation in approved enterprises by citizens of the Bahamas; and

(c) generally to promote and enhance the economic development of the Bahamas.

In discharging its duties the bank is empowered to engage in a wide range of transactions, specific among which are the following:

(a) provide finance in the form of loans, long, medium or short-term, or by the purchase of securities or by participating in any share issue of any approved enterprise;

(b) obtain funds from international agencies, financial agencies of the governments of countries outside the Bahamas, banks or other financial institutions or the public for the purpose of lending such funds within the Bahamas;

(c) invest moneys standing to the credit of the Bank by ways of loans, the purchase of securities, participation in any share issue of any approved enterprise or in any such other manner as the Bank may from time to time think proper;

(d) guarantee loans from other investment sources to persons wishing to establish or modernise any approved enterprise;

(e) act as agents for the sale and purchase of any shares or securities or for any other monetary or mercantile transactions;

(f) negotiate or pay in advance coupons and interest on public loans or securities;

(g) contract for public and private loans and negotiate any issue for the same;

(h) act as agent for any government or other authority and for public and private bodies and persons;

(i) promote, effect, induce, guarantee, underwrite, participate in, manage, or carry out any issue of government or other loans or shares or securities of any company corporation or association, and lend money for the purposes of any such issue;

(j) issue common or preferred stock and other equity securities;

(k) accumulate reserves, pay dividends, issue warrants or otherwise distribute profits.

Out of recognition of the problems being encountered by small business[55] concerns in the Bahamas there is a special section dealing with the functions of the bank in relation to such enterprises. In this connection, the duty of the bank is defined as assisting "persons who are citizens of the Bahamas in establishing, carrying on or expanding small business by granting loans and other forms of financial assistance and generally by giving advice and technical assistance to such persons". (Section II (1)).

In connection with its responsibility in this area, the bank is empowered to

(a) grant loans on such terms as to security, rate of interest, repayment of principal and other similar matters as the Bank may think fit;

(b) guarantee loans where the purpose of a loan is one for which the Bank would have power to make a loan within the provisions of the small business section of the Act;

(c) purchase, for the purpose of reselling or letting on hire or hire-purchase to persons establishing or carrying on small business, equipment, plant, tools and other articles necessary for establishing or carrying on such business;

(d) make loans to or make investments in registered co-operative societies for the purpose of enabling such societies to perform the same functions in respect of small business as is required of the BDB.

In order to advise and make recommendations to the bank in the context of its function to assist small business, a standing committee known as the "Small Business Advisory Committee" is to be set up. The composition is as follows: (a) the Chairman or Acting Chairman of the Board; (b) one other Director appointed by the Board; and (c) the Managing Director. The Committee is given power to (i) co-opt as members not more then two persons who are not directors or officers of the Bank; (ii) to invite persons who are not members of the Committee to attend meetings thereof and to advise the Committee on any particular matter; (iii) to regulate its own procedure.

One of the main functions of this committee is to examine applications for loans or financial assistance from small businesses. The granting of any such loan or assistance by the bank depends on a favourable recommendation from the Committee to which all applications are required to be referred.

As a final observation, we might point out that the bank is prohibited from engaging directly in manufacturing, agriculture, or any similar business activity, except as it becomes necessary through bankruptcies, defaults in performance of agreements or convenants, or other similar events.

The rest of the provisions which we have not touched upon relate for the most part to procedural and administrative matters, and to such other legal safeguards that are necessary for the conduct of the bank's loan operations within the framework laid down.

While development banks form an important part of the financial infrastructure of most developing countries, there tend to be many differences in operations, arising from both the structure of the institutions themselves and the peculiar national problems they confront. Basic to these differences is, of course, the perception of the role of a development bank by their creators and managers, and the importance attached to the various facets of the banks' operations. Thus, for example, although a bank may be called a 'development bank' and, in fact, may genuinely have been conceived with such a purpose in mind, development objectives may become subsidiary to the financial (or banking) aspect of its operations, sometimes deliberately out of some mistaken notion of priorities, or sometimes out of the sheer necessity to survive. In other words, if the bank comes to judge its success by the level of profits it may well find itself financing 'safe' projects which may have good financial prospects but yet be of little importance from a developmental perspective.

There is no intention to imply here that the viability of the institution is not important, or should not be taken into account in articulating and planning its activities. On the contrary, the bank can not afford to ignore the state of its own internal finances which have to be managed within certain constraints such as the limited resources at its disposal and the ability to borrow and attract outside capital. What is meant is that a balance has to be struck between the internal financial considerations and the developmental function, if the institution is to fulfil the role for which it was conceived and created.

The scope of operations which a development bank is required to assume depends on a host of factors. The more underdeveloped the economy, society and financial sector, the larger and more significant its role tends to be. In situations where, for example, the only difficulty is the lack of medium and long term credit, the function of the bank is less complex than in one where there are other critical constraints defining the development problem. For this reason, the impact which a development bank makes on an economy will depend in a large measure on the role and functions of the institution in relation to the 'indigenous' difficulties faced in the particular country. Commenting some years ago on the passive role assumed by many development banks in situations calling for a dynamic approach, a United Nations report[56] observes that while all development banks are in some way engaged in a promotional role,

> *the number that systematically takes the initiative to identify investment opportunities and assume responsibility for transforming them into viable projects is limited. Too many national development banks have instead tended to serve as passive receivers and reviewers of projects. There have been many reasons for this, including a basic miscalculation in the early days of development banking that it was enough to make credit available, and frequently a philosophical hesitation of the Government-backed banking institutions to assume the traditional private sector role of active promoter-entrepreneur. Above all, many, if not most of these institutions simply do not have the staff capability or earning power to engage in project identification, assembly and management. Legitimate concern about possible bias towards promoted projects and above the efficacy of broader promotion techniques such as sector-wide industrial surveys has hindered project preparation by the national development banks.*

We have quoted the above passage at length for the reason that it touches upon some very fundamental issues that are of relevance to the Bahamas where the tendency has been to focus overwhelmingly on finance as the major constraint to development, while other important factors have been accorded relatively little consideration. A development bank which would mobilise resources both from individual and institutional sources and channel them into industrial, agricultural, commercial, social and infrastructural projects, has, therefore, come to be widely seen as the penacea for almost all the country's economic ills. There is danger in simplifying the solution in this way, and this has been recognised, to some extent, by the people who conceived the Bahamas Development Bank and articulated its functions. One of the functions of BDB, as we have seen, is to provide advice and technical assistance to small Bahamian businessmen, which is essential in the existing circumstances.

In view, however, of the long tradition of dependence on foreign enterprise and initiative, a critical role of the bank should undoubtedly be, as the U.N. report has pointed out, the identification of investment opportunities, and in some cases the assembly of new enterprises to the point where their viability can be discerned and private interest aroused. In attempting to create a local cadre of entrepreneurs, there will also be need as part of the broader development effort, for a programme of education related to various aspects of production, marketing, management and accounting know-how, if effective use is to be made of available resources. The bank itself, undoubtedly, will have to be well equipped in terms of staff, if it is to be a meaningful instrument in the efforts being made to remove some of the many bottlenecks hindering the economic progress of the country.

A final point is worth noting. If the bank becomes involved in underwriting (or to use the broader term investment banking) as it is no doubt intended it should, the growth of this function will hinge to a critical extent on the concomitant development of a capital market in which it can dispose of securities it no longer wishes to hold, without any loss. In the absence of such a facility the bank will be forced into a very inflexible position in terms of adjustment to its portfolio and, thus, suffer seriously in its acquisition and underwriting capacity.

It would seem, therefore, from what we have said above, that for the development bank to make any significant impact on the economic environment there has to be action along a very broad front, in which the provision of finance is but only one aspect -- even if an extremely important one. The latter itself, it might be pointed out, is tied up to changes occurring in such critical areas as savings habits and investment aptitudes which form part of the larger problem of development. The role of the bank is likely to be severely restricted if its sources of funds are confined to Government finance and soft loans from official and international agencies, which are likely to be provided only in limited amounts.

Concluding Observations

The financial institutions we have discussed in this chapter both resemble and differ from commercial banks at the same time. Like the latter they intermediate between savers and borrowers, but they tend to be more specialised in their lending activities. The development bank, as indicated, while performing a banking function, is a special type of institution designed to accomplish certain objectives within a development framework. The finance companies are essentially mortgage or 'personal' lenders, using as a base funds derived from deposits, capital or borrowings. The Penny Bank and the Post Office Savings Bank are among the most insignificant financial institutions in the Bahamas. However, if they are to become part of the development thrust, there is clear need for restructuring, in terms of increasing their flexibility and efficiency. In conclusion, it can be stated that while certain non-bank financial institutions have the potential to frustrate monetary policy, this potential is derived from factors which give commercial banks the same kind of capability and, hence, can be subjected to similar administrative constraints. It is difficult at this stage to assess the reaction of financial institutions to the scrupulous deployment of central banking powers which, so far, have not really been put to the test.

On the question of competition between the commercial banks and the non-bank financial institutions, the fact that the former tend to be subjected to greater administrative constraints than the latter creates a situation where the authorities cannot easily permit any strong or overt competitive atmosphere to develop. Since this can easily lead to attitudes and policies which affect the mobilisation and efficient allocation of resources, the legal and administrative framework within which financial institutions operate must be so structured and operated that it nether encourages waste, nor stifles initiatives which might have favourable effects on growth and development. Means and objectives ought to be clearly discerned in this context.

FOOTNOTES

1. See, for example, James Tobin, "Commercial Banks as Creators of 'Money' " in Deane Carson, ed., *Banking and Monetary Studites* Homewood, Illinois, Richard D. Irwin, Inc., 1963, pp. 408—419.
2. *Ibid.*
3. *Ibid.*
4. For a detailed elaboration see John G. Gurley and Edward S. Shaw, *Money in a Theory of Finance*, Washington: The Brookings Institute, 1960. For a critical theoretical comment see also J.M. Culbertson, "Intermediaries and Monetary Theory: A Criticism of the Gurley-Shaw Theory", *American Economic Review,* March, 1958.
5. Edgar Feige, *The Demand for Liquid Assets: A Temporal Cross-Section Analysis* Englewood Cliffs, N.J.; Prentice-Hall Inc., 1964. Cited by Tong Hun Lee in "Substitutability of Non-Bank Intermediary Liabilities for Money: The Empirical Evidence", *The Journal of Finance,* September, 1966.
6. T.H. Lee, *op. cit.*
7. *Ibid.*
8. See Milton Friedman and Anna Schwartz, *op. cit.*
9. See, for example, M.J. Hamburger, "The Demand for Money by Households, Money Substitutes, and Monetary Policy", *Journal of Political Economy,* December, 1966.
10. See V.K. Chetty, "On Measuring the Nearness of Near Moneys", *American Economic Review,* June, 1969.
11. W.L. Smith, "Financial Intermediaries and Monetary Controls", *Quarterly Journal of Economics,* December, 1959.
12. *Committee on Working of the Monetary System,* CMND 827 H.M.S.O., 1960, para. 504.
13. For a short, but pointed discussion of these subjects see R.J. Bhatia and D.R. Khatkhate, "Financial Intermediation, Savings Mobilization, and Entrepreneurial Development: The African Experience", *IMF Staff Papers,* March 1975.
14. *Ibid.*
15. E.S. Shaw, *Financial Deepening in Economic Development,* London, OUP, 1973.
16. This information comes from a special Finco Supplement published with the *Nassau Guardian* 24 August, 1974.
17. *Ibid.*
18. Special supplement to the *Nassau Guardian* 3 August, 1973.
19. Originally Roywest operated both in Bahamian dollars and in foreign currencies. It is now wholly externally oriented.
20. We have treated this institution as an insurance company, although it is primarily a mortgage financer, doing its own insurance underwriting.
21. Since then the bank has functioned on a number of different Acts which have been adopted from time to time — a fact which has often led to some confusion on the date of introduction of this institution into the Bahamas.
22. See chapter on commercial banking.
23. Throughout the discussion, growth is spoken of in terms of the number of depositors or the number of deposits made per annum, rather than in terms of the number of branch offices most of which were established in the major out-islands in the first two decades of the century.
24. In 1908 the Royal Bank of Canada joined the Bank of Nassau (which was the only bank in the

country at the time), and both operated until 1917 when the latter was absorbed by Royal. See Chapter 2.

25. The attainment of independence in 1973 clearly would have legal implications for these arrangements. In practice, however, operations of the POSB have continued to be carried out in essentially the same way as in the colonial days.

26. The current rate paid is 2½ per cent per annum as compared with 4 to 5 per cent paid by the commercial banks on comparable deposits. This rate is the same as that paid in the period around the outbreak of the Second World War and ½ of 1 per cent less than that paid in the period be-1917 and 1934.

27. The maximum per account is $6,000 while the limit on deposits is restricted to $3,000 per annum for any one depositor.

28. The total deposits held by the POSB and the PPSB at the end of 1978 amounted to $3 to $4 million, or to roughtly 1.5 per cent of the $269 million held by the commercial banking sector.

29. The PPSB operates three offices, all located in New Providence.

30. This figure includes the inactive accounts at the POSB. A more accurate figure would be around 37,000.

31. Reported in the *Nassau Guardian,* 27/9/74.

32. In this connection, we need to make a few comments on Gahan's observation about Government's involvement in banking operations, which we noted in Chapter 2 in our discussion of the Public Bank of the Bahamas (PBB). This institution collapsed, it is worth noting, not because of Government's ownership per se, but because, as Gahan himself pointed out, of the absence of a proper accounting system, the lack of control and procedures, and the failure to institute a regular audit of the bank's records. The PBB was, in fact, left entirely in the hands of one man who acted in the capacity of cashier/manager for most of the bank's life. While at no time was the cashier accused of fraud or dishonesty, a communication from the office of the local Governor to the Colonial Office dated 4/4/1885 described him as "quite unfit, postponing always the exigencies of banking safety to the wish to serve the importunate borrowers who claimed his friendship". The PBB, it should be pointed out, served mainly a privileged minority who appeared bent on bilking it. In another communication the Governor lamented the fact that the bank seemed to have drifted into one of "running accounts, exchange and accommodation to which three quarters of the white population are indebted". Given the make-up of the government of the day, it was no wonder it was willing to close its eyes to the manner in which the bank was being operated.

    Note that the above comment is not meant to make out a case for government ownership as against private ownership, but merely to put Gahan's remarks in some kind of perspective.

33. For a brief description of the working of the system see Jack Revell, *The British Financial System,* London, The Macmillan Press Ltd., 1973, pp. 161–166. For a more complete discussion on various aspects of British Giro see, Glyn Davies, *National Giro: Modern Money Transfer* George Allen & Unwin Ltd., 1973.

34. In March of 1975, the Secretary of State for Industry announced that the Giro would be allowed to enter the overdraft market.

35. As far as the statistics in this section are concerned, they relate only to incorporated operations specialising in trust activities. The functions discussed, however, apply equally to the trust departments of the commercial banks who attempt to provide the widest range of services in order to avoid losing business to competitors.

36. Sometimes, however, other factors are involved. These might include a desire to provide financially for oneself or for one's family, in the event of a political upheaval such as war, coup d'etat or racial persecution (See Milton Grundy, "The Offshore Trust", *The British Tax Review,* 1971).

37. A 'managed company' is not a legal term implying a special type of company. It is an ordinary company formed for non-operational purposes and entrusted to the management of a concern providing this service.

38. Unlike some jurisdictions no special Act of the Legislature is required to incorporate a company in the Bahamas. In fact, ease of incorporation is one of the special attractions of the Bahamas.

39. Anonymity can be attained by the use of nominees which can be provided by the managing company.

40. The same applies to directors and officers.

41. This provision of the law explains the eye-catching brass plates along Bay Street. Many companies without staffed offices in the Bahamas, have designated the chambers of a lawyer (normally the one who handled the incorporation) or office of an accountant as their Registered Office. Trust companies are also used for such a purpose.

42. The procedure is so simple, that a company can be organised in a matter of days. As to the costs of formation, this varies with the authorised capital on which stamp duty is payable. If the capital is $5,000 or less, the charge is $60; if it is more the duty rises accordingly.

43. T.C.B. *Annual Report,* 1972.

44. *Ibid.*

45. These techniques are discussed in more detail in a later chapter.

46. These take several forms. Generally, however, they vary with the type of service required. the degree of responsibility entailed, and the nature and volume of work involved. For certain services, charges are fixed beforehand as can be seen from the following extract taken from an advertisement.

    Trust

    Annual fee: ¼ of 1 per cent of the market value of the trust, payable semi-annually in arrears. Minimum $500 per annum.

    Distribution fee: 1 per cent of the value of funds distributed to beneficiaries or withdrawn from trust.

    Handling Charges: 15 per cent per purchase or sale of stocks or bonds.

    Custody

    Annual fee: ¼ of 1 per cent of the market value of the amount, payable semi-annually in arrears.

    Handling Charge: $15 per purchase of sale of stocks or bonds.

    Services related to the management of a company cost a minimum of about $1,000 per annum.

47. Because of the obvious confidentiality attached to this aspect of the trust companies' business, it has not been possible to get an idea of the size of the sums involved. However, if we are to be guided by the figure advertised by one concern (over $300 million) it is clear that the trust companies have at their disposal tremendous resources which they can easily switch around taking advantage of the highest possible returns in their disposition.

    It should be noted that even in the United States the exact magnitude of such funds at the disposal of fiduciaries is not known. Suchhasbeen their impact on financial flows in that country in recent years, however, that a great many questions have been raised about their investment activities and the principles which guide them. In its 1972 Annual Report, the Chase Manhattan Corporation was moved to make the following statement: "Concern has been expressed in some quarters that accumulations of common stock holdings in individual companies could be used by fiduciaries to exercise an inappropriate degree of control over American business. We do not make investments on this basis. Our transaction or recommendations are based on broad investment considerations and not with a view to influencing the management of companies. Where the responsibility to exercise proxies is delegated to us, we base our judgements on the best interest of the particular accounts involved.

    We do not agree with suggestions that fiduciaries should be subject to mandatory limits on the amount of stock they hold in one company even though we ourselves follow policies that limit accumulations. These are designed to maintain appropriate diversification and to improve market flexibility. However, these limits vary considerably and are dependent upon the size of the company and the market for its securities. We believe that flexibility is essential if we are to serve our customers effectively and perform the broader economic functions of supplying needed capital to both large and small companies".

48. In addition, it should be pointed out that there are a few other firms which have resident status, i.e. they are permitted to conduct business in Bahamian dollars, yet seem to concentrate all their attention exclusively on overseas activities.

49. *Independence for the Commonwealth of the Bahamas,* White Paper, *op., cit.,* p. 27.

50. *ibid.*

51. At the time of writing $4 million has been fully paid-up – all by the Government. In addition to the paid-up capital Government has also made available to the Bank a loan of $1 million at an interest rate of 2 per cent per annum. In 1978, an agreement was reached with the Caribbean Development Bank for a line of credit amounting to US$3 million. This is to be used for agricultural and industrial development. In 1978 an undertaking was also received from the European Development Fund for a line of credit amounting to roughly B$900.000.

52. For example, see *Independence White Paper, op. cit.,* p. 27.

53. One author has argued that the purpose of a development bank is to help stimulate the emergence of the missing ingredients necessary for development. These factors include in varying mixes capital, entrepreneurship, technological and managerial capabilities, promotional activity, capital market activity, and availability of foreign exchange. He argues that these factors cannot be created in sufficient quantity by the bank itself, no matter how sizeable its resources may be. But the bank can further economic development by supplying catalytic increments of the missing factors on its own initiative. See, Joseph A. Kane, *Development Banking,* Lexington, D.C. Health and Company, 1975 , p. 15.

54. Total loans approved in 1978 were distributed as follows:

	$'000	**%**
Manufacturing	554.0	37
Agriculture and Fisheries	321.9	21
Tourism	409.3	27
Small Business	71.8	5
Others	150.0	10
Total	**1,507.0**	**100**

55. In the part of the legislation outlining the special functions of the bank in relation to small business, the latter is defined as "an enterprise of an industrial, commercial, agricultural, manufacturing or servicing character", which appears to cover everything. This vagueness of course leaves the bank with a great deal of discretion in determining what is, and what is not a small business.

56. United Nations, *Foreign Investment in Developing Countries,* New York, 1968, p. 44. Sales No. E. 68, II. D. 2.

CHAPTER 5

NASSAU AND THE EURO-CURRENCY MARKET

Introduction

In our discussion on commercial banking, we made reference to the fact that the banks engaged in domestic activity were also deeply involved in the international foreign currency business, which, it was shown in several instances, heavily out-weighed the volume of their local operations. In addition to these banks, there are a large number of institutions with a limited presence in the Bahamas, whose operations are exclusively oriented to the Euro-currency market. Besides these entities, there are a number of offshore investment and merchant banks and trust companies which are located in the Bahamas for tax and other reasons, but which for the most part, service an external clientele. The operations of this latter group of institutions include some participation in the Euro-currency business, though no data are available on the depth of involvement. As can be seen in Table 5.1, at the end of 1978, there were 190 bank and/or trust companies holding a public licence. If the 16 authorised dealers and agents were to be excluded, the remaining figure of 174 would comprise 104 Euro-currency branches of foreign banks, 41 foreign owned subsidiaries and 29 other institutions (also locally incorporated) which have their principal office in the Bahamas. With the exception of the People's Penny Savings Bank, the latter were all foreign owned.

Of the 104 Euro-currency branch banks, 82 were branches of banks based in the United States. It can be seen in Table 5.1 that this heavy presence is a recent phenomenon, dating back only to the late '60s. In order to understand the factors behind this unusual expansion and the functions and nature of these branches, it is necessary to have some idea of the workings of the international market in foreign currency and some of the recent developments affecting its growth. In the final section of the chapter, we shall examine the role of the Bahamas and the possible effects of Euro-currency operations on the domestic financial system.

Growth of the Euro-currency Market

Despite the growing volume of literature on the Euro-currency market, there are still many unresolved issues and questions relating both to the nature of the market and its exact dimensions. One of the major reasons for this situation, undoubtedly, stems from the lack of adequate data and the rapid expansion and evolution which have been witnessed in the last two decades. While, however, it is difficult to say very much on such aspects like the sources and use of funds, we are able on the basis of statistics

TABLE 5.1

HEAD OFFICE LOCATION (BY COUNTRIES) OF BANKING AND TRUST INSTITUTIONS LICENSED TO DEAL WITH THE PUBLIC IN OR FROM WITHIN THE BAHAMAS 1967–1978

Type of Presence and Country of Head Office	1967	1969	1971	1975	1977	1978
Branches of banks based in:						
U.S.A	2	35	80	82	81	84
Canada	4	4	4	3	3	3
U.K.	1	1	1	2	3	4
Israel	—	1	1	1	1	1
South America	—	—	—	3	3	3
Other Countries	—	—	—	8	12	16
1. Sub-Total	**7**	**41**	**86**	**99**	**103**	**111**
Wholly owned subsidiaries of banks located in:						
U.S.A.	4	8	9	9	12	13
Switzerland	2	8	12	11	12	13
Canada	7	7	6	5	7	6
U.K	2	2	4	3	3	4
France	2	2	—	—	—	—
South America	1	2	1	—	—	—
Italy	—	1	1	4	5	5
Other Countries	—	—	—	2	2	4
2. Sub-Total	**18**	**30**	**33**	**34**	**41**	**45**
3. Others[a]	**65**	**55**	**63**	**35**	**34**	**34**
1 + 2 + 3	**90**	**126**	**182**	**168**	**178**	**190**

a: Banks incorporated in the Bahamas and having their principal office here. Almost all of these are foreign owned.

Source: Central Bank of the Bahamas; *Statistical Abstract,* 1970, Department of Statistics, Nassau.

published by the Bank of International Settlements (BIS), to get a fairly good indication of the growth of the Euro-market business from the early '60s to the present time.

An examination of data presented in Table 5.2 shows that the gross size of the market (represented by the external currency liabilities of European banks reporting to the BIS) grew from $12.3 billion in 1964 to $510.8 billion at the end of 1978.[1] One problem of course with these figures is that they tend to reflect a certain amount of double counting arising from inter-bank deposits. Even when viewed in net terms (net, that is of double counting arising from inter-bank business within the reporting area), however, it has been estimated that the European segment of the Euro-currency market grew from about US$1 billion in 1957 to US$375 billion at the end of 1978. If we include the foreign currency liabilities of banks in other major centres (the Bahamas, Bahrain, Cayman Islands, Panama, Canada, Japan, Hong Kong and Singapore) it has been estimated[2] that the gross size of the market grew from US$110 billion at the end of 1970 to US$860 billion at the end of 1978. The net size increased from US$65 billion to US$480 billion over the same period. The U.S. dollar component is the largest of the markets and this explains why the whole system is often referred to as the Euro-dollar market. In recent years, however, there have been some noticeable changes in structure. The U.S. dollar segment, which was the earliest of the markets to develop, has been falling consistently over the last decade in relation to the others which make up the system. The U.S. dollar market contribution is estimated to have dropped from over 80 per cent in 1970 to just over 70 per cent in 1978. The fastest growing of the other segments which are based on the currencies of certain European countries is the market involving the D-mark (See Table 5.1). In terms of structure, it is worth noting that there is both a short end and a long end to Euro-currency activities. The latter component has been termed the Euro-bond market.

Factors Affecting the Growth of the Euro-dollar Market

While commercial banks at various times before the late '50s (the period which observers cite as the starting point of the Euro-currency markets), had accepted foreign currency deposits (i.e. deposits in currencies other than that of the country in which they are located), such transactions never constituted an international market, or possessed the scale and systematic character which are known to underlie present day dealings in certain foreign currencies particularly, as we have indicated, the U.S. dollar.[3] Though the reasons for the emergence of the Euro-dollar market as a form of private international finance are not quite clear, there is widespread speculation among observers that the practice by certain state banks in Eastern Europe of holding their dollar balances with banks in Paris and London for security reasons in the immediate postwar years may have provided the initial spark. Other contributory factors include the British Government's decision, in 1957, to restrict the use of sterling in international trade, the return to convertibility in Western Europe in the late '50s, the huge United States balance

TABLE 5.2

EXTERNAL POSITIONS OF BANKS OF REPORTING EUROPEAN COUNTRIES[a] IN DOLLARS AND CERTAIN OTHER FOREIGN CURRENCIES, 1964–1978

U.S $ billion

End of Period	U.S. Dollars vis a vis Banks	Non-Banks	Total	Other Foreign Currencies Banks	Non-Banks	Total	D-Marks	Swiss Francs	Pounds Sterling	Guilders	French Francs
					Liabilities						
1964			9.7			2.6					
66	10.7	4.1	14.8	3.1	0.5	3.6					
68	20.7	6.2	26.9	5.6	1.1	6.7	3.0	2.3	0.8	0.3	0.2
70	47.5	11.2	58.7	13.6	2.3	15.9	8.1	5.7	0.9	0.6	0.4
72	84.9	11.8	96.7	31.6	3.6	35.2	19.5	8.8	2.2	1.4	1.1
74	134.2	22.2	156.4	56.2	8.1	64.3	34.4	18.3	3.6	2.8	2.8
76	200.5	29.5	230.0	71.6	9.0	80.6	47.2	15.9	4.0	3.5	3.2
78	304.3	44.3	348.6	145.6	16.6	162.2	93.1	27.9	10.3	7.4	7.4
					Assets						
1964			9.0			3.0					
66	14.0	2.1	16.1	3.1	0.7	3.8					
68	25.3	5.1	30.4	5.5	1.5	7.0	3.9	1.8	0.6	0.3	0.2
70	48.5	11.9	60.4	13.2	4.7	17.9	10.1	5.1	0.6	0.6	0.4
72	79.7	18.3	98.0	25.8	8.0	33.8	20.4	7.8	2.2	0.7	0.7
74	121.3	34.9	156.2	40.9	18.0	58.9	35.0	14.4	2.0	1.9	1.5
76	173.2	50.8	224.0	58.6	22.7	81.3	48.7	17.9	2.1	3.8	2.6
78	255.3	84.2	339.5	119.5	42.9	162.4	97.4	27.9	7.3	6.9	5.7

a: Up to December 1977, the reporting European area included Belgium – Luxembourg, France, W. Germany, Italy, Netherlands, Sweden, Switzerland (including Euro-currency assets and liabilities of BIS) and the United Kingdom. Since December, 1977, it also includes, Austria, Denmark and Ireland.

Source: Bank for International Settlements, *Annual Reports.*

of payments deficits built up in the postwar period and the relatively lower interest rates paid on deposits in the U.S. during the '60s, as compared to those prevailing in Western Europe. In recent years the foreign exchange surpluses accumulated by the oil exporting countries and the increasing demand for large investment funds have served to provide further momentum to the rapid expansion experienced during the 1960s. The increasing participation of official institutions in the market, either as borrowers or lenders, reflects the significant role, both in terms of scope and functions, which the Euro-currency system has come to achieve in recent times.

It has been observed that the Euro-currency market does not form an "autonomous international banking system, separated from major national markets and possessing a life of its own".[4] It competes with domestic markets. A critical instrument used to attract funds away from the latter is the offer of higher interest rates which are not generally subject to official regulations. The fact, too, that Euro-banks[5] have to induce borrowers (at least when competing funds are available in national markets) means that loan rates also have to be lower. In practice this means that they operate on smaller margins than in domestic markets where competition is often quite restricted and funds are at a premium. The banks are able to meet these conditions and still come out with a profit by engaging in what is called wholesale banking, i.e. by dealing in large amounts,[6] (which avoids many of the clerical expenses involved in retail operations). The size of a deposit or loan rarely falls below half a million dollars. While a typical deposit ranges between $1 million and $5 million, sums of the magnitude of $10 million, $50 million and more recently $100 million are not uncommon. Another factor contributing to the lower costs of Euro-currency activities is the absence of reserve requirements, which permits a greater degree of flexibility in operation. Yet, another reason why the Euro-currency market is able to charge lower rates than those obtaining in conventional sources, lies in the essentially inter-bank nature of the system and the operating practices followed, which tend to minimise the risks involved, even though loans are generally unsecured. Not only is the credit worthiness of participants generally well known in the market, but most banks tend to observe loan ceilings with respect to lending to any one institution. A very common practice is the matching between deposits and loans in terms of size, maturity and currency, making such transactions self-liquidating, and thus considerably reducing the risk for the bank concerned in being able to meet its liabilities.

Operation of the Market

It should be pointed out at the very outset that the term Euro-currency is not the name of a currency different in physical characteristics from national currencies, but refers to a particular type of operation.[7] Although the prefix would seem to suggest that all dealings are in one way or another connected with Europe, in practice participation, which takes place through the international telephone and telex network, is worldwide, involving banks widely dispersed and borrowers and lenders of almost all nationalities. The term 'Euro' seems to have its origin in the fact that the market had its beginnings in Western Europe, which, incidentally, is still the centre of operation, though specialised Euro-currency functions are carried out in countries such as Beirut, Bahamas, Hong Kong, Singapore, Panama, Luxembourg, the Cayman Islands and Bahrain. The latter centres are often described as 'offshore' because the funds that pass through these areas are largely beneficially owned by other countries. In fact, as we shall see later, a great deal of 'offshore' banking is conducted from onshore centres such as New York, London and Zurich. As booking centres, these offshore countries are important because of the absence of regulations and taxation imposed by the respective authorities on Euro-currency operations. From the point of view of costs, they offer an additional advantage. Other factors which help to differentiate between locations relate to time zone differences, communications facilities, availability of skilled personnel and local political and economic conditions.

One of the earliest attempts at defining a 'Euro-operation' by an international institution was made in 1964 of the Bank of International Settlements (BIS) which saw a Euro-dollar as "a dollar that has been acquired by a bank outside the United States and used directly or after conversion into another currency for lending to a non-bank customer, perhaps after one or more re-deposits from one bank to another".[8] Not quite satisifed with this definition, the BIS in its 36th Annual Report had a second try defining Euro-activities as "the acquisition of dollars by banks located outside the United States, mostly through the taking of deposits but also to some extent through swapping other currencies into dollars, and the re-lending of these dollars, often after re-depositing with other banks, to non-bank borrowers anywhere in the world".[9] As Einzig has pointed out this definition (either version) is too restrictive as it excludes a very high proportion of the foreign dollar deposits which have been lent to some non-resident banks but which have not been re-lent to non-banking customers".[10] For Klopstock, "Euro-dollars come into existence when a domestic or foreign holder of dollar demand deposits in the United States places them on deposit in a bank outside the United States, but the term also applies to the dollars that banks abroad acquire with their own or foreign currencies and then employ for placement in the market for loans to customers".[11] In the interest of simplicity, a Euro-dollar can broadly be defined as a dollar deposited with a bank outside the United States (including a United States branch) and held to the order of a foreigner or an American resident. The market in Euro-dollars (or for that matter in any other currency), it must be stressed, is essentially a deposit market. No buying or selling of currencies is involved. The term 'deposit' however is to some extent misleading. "For properly speaking, the 'placing' and 'taking' of Euro-dollar deposits is a loan transaction which involves not the exchange of one currency against another but a loan in terms of a foreign currency, payable in the same currency."[12]

From the above collection of perspectives, it can be seen that a Euro-dollar transaction is essentially concerned with a type of operation or, if one likes, a process by which the national currency of one country is acquired by banks resident in other countries and re-deployed in their respective domestic credit markets, or on-lent to other financial institutions in the home country or elsewhere, including the country whose currency is involved. It should be pointed out, however, that no physical movement of currency is involved, which means that the volume of cash in circulation within national boundaries is not affected by Euro-currency transactions. The operation is essentially concerned with the transfer of claims between borrowers and lenders, which, as we indicated before, take place through the international telex and telephone network.

As indicated earlier, there are several aspects of the Euro-currency market which are the subject of a great deal of controversy in the theoretical literature. Some of the issues which we might briefly mention relate to the sources and uses of funds, the size of the banking multiplier (if there is one), the impact on the balance of payments and money supply of certain countries, the implications for monetary policy, the effects on exchange rate flexibility and the contribution to world inflation. Needless to say, these subjects are beyond the scope of this study.

In the rest of this chapter, we look at the role of Nassau in the new international money markets and discuss the ways in which, and the possible extent to which domestic monetary aggregates can or may be affected by the association.

The Trek to Nassau

One of the most remarkable features of international banking in the period since 1960 has been the rapid overseas extension of American banks, so much so that by the late 1960s the U.S. had become the country with the largest number of banks operating foreign offices.[13] Whereas between 1950 and 1960 the number of banks with foreign branches increased from 7 (with 95 branches) to 8 (with 131 branches), by the end of the following decade the number had grown to 79 (with 536 branches) and by September 1974 to 129 (with 737 branches). An examination of Table 5.3 (which presents data on the number of branches in various areas together with assets held) reveals that while expansion was experienced in all regions, particularly noticeable was the spectacular growth in the Bahamas, where the number grew from 7 in 1968 to almost 100 in 1972. Altogether, the total number of overseas branches from 295 in 1967 to 627 in 1972, or by more than 100 per cent. Even more remarkable was the growth in assets held by foreign branches, the figure increasing from \$15.7 billion in 1967 to \$77.4 billion in 1972 and to \$151.9 billion at the end of December, 1974. Of this latter figure, more than two thirds or \$106.0 billion were payable in U.S. dollars, indicating the deep involvement of the overseas branches in the Euro-dollar business.

Although at the end of 1972, more than one half of the total assets held by foreign branches was concentrated in London, from the figures,

TABLE 5.3

REGIONAL STRUCTURE: EXPANSION OF U.S. BRANCH-BANKING OVERSEAS, 1967 – 1972

Location	1967	1968	1969	1970	1971	1972
			Number of Branches			
U.K. & Ireland	25	35	40	44	48	53
Continental Europe	34	46	64	72	80	89
Bahamas [a]	2	7	31	61	73	94
Latin America	131	171	203	223	229	227
Far East	63	72	76	79	83	97
Near East & Africa	9	9	7	14	17	17
U.S. Overseas Areas & Trust Territories	31	35	38	43	47	50
Total Branches	**295**	**375**	**459**	**536**	**577**	**627**
			Assets in $ m. (US)			
U.K. & Ireland	8,178	13,177	24,753	29,668	35,143	40,915
Continental Europe	2,721	4,121	6,464	9,496	12,913	13,033
Bahamas	b	b	2,993	4,421	7,849	11,576
Latin America	1,270	1,736	1,584	2,055	2,519	2,602
Far East	2,267	2,663	3,257	4,423	6,221	7,119
Middle East & Africa	257	284	265	315	384	386
U S. Overseas Areas & Trust Territories	965	1,037	1,804	2,233	2,025	1,807
Total Assets	**15,658**	**23,018**	**41,120**	**52,611**	**67,054**	**77,438**

a: There is a slight discrepancy between these figures and those in Table 5.1.

b: Included in Latin America.

Source: E.P. Imhof, "Rapid Expansion of Overseas Banking", *Inter-economics,* August 1974.

it would appear that the Nassau segment has been experiencing the fastest growth rate, with total assets[14] at the end of 1972 amounting to $11.6 billion as compared to an estimated less than one billion in 1967. Since then, the figure has continued to grow though we can provide no precise data on assets held by branches of U.S. banks in the Bahamas. The official statistics published by the Federal Reserve Board since August, 1973 reflect the position of banks in both the Cayman Islands and the Bahamas. The provisional figure relating to these two countries at the end of May, 1979 was U.S $97.3 billion. An examination of Table 5.4 shows that bank activities in the Euro-currency system tend to consist of two parts. One is the placement of funds with each other (the inter-bank market) and the other is an intermediary function i.e. the lending of funds placed with them to final users. The former include the granting of credit to parent banks. While in recent years claims on banks outside the U.S. tend to be the largest single item in the balance sheet, loans to the parent bank have been assuming increasing significance. It should be noted that over 90 per cent of the total claims outstanding tend to be repayable in U.S. dollars. In terms of sources of funds, the offshore centres or 'windows' are closely linked to the London market in which they apparently also participate in the provision of bankline credit. Table 5.5 provides some data with respect to the asset/liability position of U.K. banks vis a vis certain selected jurisdictions. The importance of the Bahamas among the available 'windows' is clearly evident from the table.

Before going on to discuss the particular attractions which Nassau offers as a centre for foreign banking, it is appropriate at this point to discuss some of the factors which have led to the great interest by American institutions in overseas activities over recent years.

Two significant considerations which have influenced international expansion have, undoubtedly, been the growth in world trade and the desire to secure a part of the business in certain markets, both in developed and developing countries, where economic activities have led to a growing need for banking services. Perhaps, an even more important factor has been the growth of U.S. foreign direct investment and the opportunities created by the varied and extensive needs of the multinational corporations. Another development which also had a critical impact on the decision by American banks to establish foreign offices was the policy measures instituted by the U.S. government during the 1960s in order to deal with the persistent deficits in that country's balance of payments.

The first of these measures was the announcement in July, 1963,[15] of the Interest Equalization Tax (IET) which imposed a special tax on purchases by Americans of foreign equities and debt obligations of three or more years maturity. The thrust of the legislation was not so much to prohibit borrowing altogether in the New York market as to discourage the outflow of long term portfolio capital to the developed countries of Western Europe where the costs of borrowing were believed to be higher. As such, purchases

TABLE 5.4

CLAIMS (ALL CURRIENCIES) OF BRANCHES OF U.S. BANKS BASED IN THE BAHAMAS AND THE CAYMAN ISLANDS BY BORROWERS 1973 TO 1979

U.S. $ Million

	Claims on the U.S.		Claims on Foreigners					
End of Period	Parent	Other	Other Branches of Parent Bank	Banks	Public Borrowers	Non-Bank Foreigners	Other Assets	Total Assets
1973	317	1,893	1,928	9,895	1,151	8,068	520	23,772
74	1,081	1,382	3,478	11,354	2,022	11,601	815	31,733
75	1,477	1,752	5,411	16,298	3,576	15,756	933	45,203
76	1,141	2,367	8,144	25,354	7,105	21,445	1,218	66,774
77	3,051	2,731	11,120	27,939	9,109	23,503	1,599	79,052
78	5,779	3,206	12,906	33,675	11,514	21,679	2,326	91,085
79[a]	11,519	4,166	11,886	34,006	12,702	20,215	2,823	97,317

a: End of May (provisional) figures.

Source: Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin,* various issues.

TABLE 5.5

EXTERNAL CLAIMS AND LIABILITIES OF U.K. BANKS (IN FOREIGN CURRENCIES) VIS A VIS OFFSHORE BANKING CENTRES, 1971 TO 1979

£m.	End of Period								
	1971	1972	1973	1974	1975	1976	1977	1978	1979[a]
U.K. Liabilities									
Bahamas	313	524	893	1,127	2,281	4,043	2,987	4,240	3,763
Bermuda	212	319	456	690	814	1,107	247	1,325	1,342
Cayman Islands	1	27	174	245	691	1,465	1,701	2,515	2,140
Hong Kong	85	158	560	957	1,380	1,852	1,806	1,584	1,659
Lebanon	166	215	217	603	753	862	951	981	734
Liberia	92	120	276	277	299	457	381	498	459
Netherlands Antilles	70	84	96	113	149	273	219	343	503
New Hebrides	–	–	2	8	2	6	13	16	19
Panama	348	403	673	803	749	1,160	948	931	1,040
Singapore	31	91	347	480	652	815	871	1,318	1,270
U K. Claims									
Bahamas	1,108	1,888	2,994	3,025	5,363	6,887	5,934	7,257	7,772
Bermuda	57	81	115	144	136	168	208	252	311
Cayman Islands	6	24	244	406	1,333	1,817	1,552	1,974	1,863
Hong Kong	21	113	435	965	1,528	1,788	2,149	2,628	2,602
Lebanon	12	6	37	52	69	52	37	43	54
Liberia	90	187	448	565	813	1,149	954	1,018	948
Netherlands Antilles	230	259	271	154	183	226	245	254	394
New Hebrides	–	–	29	27	19	9	9	16	17
Panama	279	433	802	1,087	1,390	1,664	1,326	1,619	1,283
Singapore	167	392	664	1,237	1,742	3,254	3,089	3,028	2,980

a. At 29 June.

Note: The 1978 and 1979 figures have been converted from U.S. dollars to sterling at rates prevailing at the time to which the data relate.

Source: Bank of England, *Quarterly Bulletin*, various issues.

from less developed countries were largely exempt, as were purchases from Canada, other U.S. holders and the first $100 million from Japan. The IET legislation, it should be noted, did not cover U.S. direct investment abroad, obligations required in financing U.S. exports and bank loans by foreign branches of U S. banks to foreign borrowers. While the imposition of the tax had an immediate impact on taxable outflows, a not altogether unforeseen consequence was a rapid increase in non-taxable outflows, particularly of term bank loans to European firms. Continued deterioration in the balance of payments which recorded a mammoth $6 billion private capital outflow in 1964 led to the adoption of a new set of measures in 1965, among which was the Voluntary Foreign Credit Restraint (VFCR) programme which was aimed at the foreign lending of commercial banks and other non-bank financial institutions which were urged to ensure that credit to non-residents rose by no more than 5 per cent[16] (increased to 9 in 1966) of the amount outstanding at the end of 1964. For a time the VFCR proved quite successful in reducing short term capital outflows which were its main target. Foreign lending, however, picked up again in 1967, lending to the introduction of more restrictive guidelines at the beginning of 1968, though they still retained their voluntary character. The main features of this programme were a reduction in banks' lending to non-residents from 109 to 103 per cent of the end-1964 base figure and an exhortation to the banks not to make any new long term loans, or renew maturing loans to the developed countries of Western Europe. In addition, the banks were asked to reduce, during the course of 1968, outstanding short term credit to these countries by 40 per cent of the amount outstanding at the end of 1967 at the rate of 10 per cent per quarter. Together with these measures aimed at financial institutions, an appeal was also made in 1965 to business corporations to limit the outflow of funds to foreign affiliates in developed countries. By 1968 a mandatory programme was instituted with the aim of controlling direct foreign investment by putting a ceiling on outflows, which varied from 35 per cent to 110 per cent above the 1965-66 base year figure, depending on which one of three Scheduled Areas[17] the recipient country fell. Since these limits applied only to transfers from the U.S. they did not affect investment financed by external borrowings, thus allowing corporations unlimited freedom to external capital markets in order to finance their overseas activities to any extent they thought desirable.

Though all these measures were intended to improve the U.S. balance of payments position which had become a matter of grave concern in official circles, they produced a number of repercussions on international banking and finance with many far-reaching consequences that were difficult to foresee. A major effect was to encourage the establishment of overseas offices by many U.S. banks in order to serve the needs of clients doing business abroad and to take advantage of the expanding opportunities which the IET and other investment controls had helped in creating. Once the advantages of having a foreign office were demonstrated by a few pioneer banks, many institutions followed, particularly with the object of gaining a foothold in the growing Euro-dollar market which was discovered to hold many advantages in the context of their domestic operations in the United States.

> *By far the greatest merit of the market from the viewpoint of the United States banks is that it offers the possibility of obtaining balances that are not subject to the regulatory restriction applicable to demand and time deposits. Unlike the United States banks, the overseas branches may pay interest on dollar call deposits and on time deposits with maturities of less than thirty days. Thus, the United States banks can gain access through the overseas branch route to sizeable amounts of funds that they are precluded by various regulations from acquiring directly from foreign depositors. In addition, balances payable at overseas branches are not subject to Regulations Q rate ceilings, a factor of great significance when rates for money market instruments in the United States or Euro-dollar rates rise above the ceiling rates payable on deposits. And, finally, branch balances placed in head offices are not subject to member bank reserve requirements*[18] *or to the fees of the Federal Deposit Insurance Corporation (F.D.I.C.). Indeed, especially during periods of tight money, the differential between Euro-dollar rates and time deposit rates in the United States tends to reflect this savings.*[19]

As the focal centre of the Euro-dollar market, it was obvious that many of the banks which were not already represented in London by the mid-1960s would seek to locate at least one office there. The number of American banks with branches (or representative offices) in the City increased from twelve in 1964 to thirty-one in 1969. The cost of establishing a London office, however, (which the Bank of England insists must be full service) is fairly substantial and has tended to move upwards with the great competition for space in the financial districts. Faced with this prospect, many of the smaller and medium-sized institutions have sought entry into the market through the establishment[20] of limited service branches (sometimes referred to as 'shells' or 'cubicles') in such places like Nassau (and to a lesser extent in the Cayman Islands), which can be used to great advantage in attracting deposits and conducting loan operations. While there are some disadvantages of doing business through a limited branch in Nassau, such as the "isolation from personal contacts with the major participants in the market and the time differential between working hours in London and the Bahamas",[21] the advantages have proved to be far more overwhelming, and this is reflected in the rapid influx since 1966. One of the most important of these, as indicated above, is the cost factor. Compared to a full-service office in London which involves physical facilities and on the spot personnel, operating a 'shell' branch which is just as useful for wholesale business, is relatively inexpensive, requiring, as it does, only minimal administrative expenses. While operating a medium Euro-dollar bank with its own manager, personnel and premises can be as high as B$40,000, it is possible, by using a local agent (a lawyer, a locally based bank or a trust company), as branch manager, to keep expenses to less than $5,000 per annum.[22] One agent may, and often does, also act as 'branch manager' for several banks at the same time. Their role is largely a book-keeper's one, recording the transactions carried out at the banks' home offices in the U.S. which keep a duplicate set of records and make all decisions with regard to the taking and lending of deposits. "When loans are negotiated, the officers in the head office merely advise the borrowers that the advance will be made from their Nassau office. Similarly, the officers in the head office solicit deposits directly through brokers which are recorded on the Nassau books."[23] No funds actually reach Nassau. "In most cases, the Nassau branch maintains a clearing account in New York and in other countries for other currencies. Depositors forward their funds to the clearing account at a New York Bank. Loans are disbursed by debiting the same clearing account and transferring the funds to wherever requested by the borrower."[24] By resorting to this kind of operation, banks who otherwise would be unable to enter the Euro-dollar business are able to generate relatively high rates of return on limited volume.[25] Another advantage to be derived from limited service operations being conducted from head office is in the area of staffing which can easily draw upon domestic banking personnel and facilities often located in the same building, with great advantage in economy and training experience. Because of the time zone difference between business hours in New York and Europe, it has also been found that Nassau branches are "better located than European branches to provide timely Euro-currency rates to customers in the U.S., Canada and Latin America. Furthermore, for banks with worldwide branch networks, a Nassau location permits the use of international cash management technique associated with being open 24 hours a day".[26] As a haven country, an office in the Bahamas also offers the parent a device for reducing overall tax liability by permitting U.S. source income on offshore transactions and foreign source income to generate through a Nassau branch.

> *Moreover, while U.S. banks with foreign branches, including limited service Nassau branches, are always subject to U.S Federal tax liability at full effective rates on taxable income from offshore branches, operations in Nassau, which has no corporate tax, provide certain banks with the ability to absorb an increased amount of the foreign corporate taxes withheld in other countries. In contrast, the tax rates in many other countries are well in excess of U.S. tax rates.*[27]

There are two main locations in the Caribbean Area competing for Euro-dollar banks, viz. the Cayman Islands and the Bahamas.[28] The former, which at the end of 1977 had over 200 banks and trust[29] registered there, became particularly attractive in the late '60s in the wake of growing uncertainty over the policy of the Bahamian Government towards the tax haven business. The Bahamas, of course, with its longer experience and better infrastructure, including good air transport and telecommunication facilities, is still the more popular of the two, as the statistics indicate. Both countries enjoy the advantage of no income, profits or withholding taxes, of being near the United States, the operation of the British system of laws, and a history of fairly stable political life which is important to the tax haven business. The latter factor, however, is not of tremendous importance to 'shell' banks which, as we pointed out earlier, are really book-keeping offices, the bulk of them having no physical assets. In the event of nationalisation, these 'banks' or their depositors stand to lose nothing since the repayment of loans and return of depositors funds can be done through New York clearing accounts mentioned earlier.[30]

General Control Measures

The emergence of the Euro-currency market has had a marked and generally welcome effect on international liquidity in the context of expanding foreign trade and investment. This is reflected in the increasing use that is being made of it by governments and private organisations, both as a source of funds and as a channel for employment of surplus resources. At the same time, however, the increased mobility which the market has had on the movement of short term capital responding to interest rates differentials or speculative pressures has posed serious problems to the monetary and exchange rate policies of a number of countries in recent years, and even to the workings of the postwar international monetary system itself. With the internationalisation of banking and the consequent flow of resources between national money markets, central banks have found themselves having to institute measures to control both inflows and outflows in an effort to insulate national economic policies from their effects.

Basically, there are two distinct approaches to exchange controls. One is the outright prohibition of certain transactions. The other is the use of market oriented weapons which discourage net inflows (or outflows) of funds by changing the cost calculations of bankers and businessmen.[31] The prime example is the two-tier market in which 'desirable' transactions (normally commercial settlements) are allowed access to the officially supported exchange market, while 'undesirable' transactions (usually those deemed most vulnerable to speculation) are pushed into a separate market in which the exchange rate is allowed to float in response to pressure.[32] There are a number of other market-type controls which are directed specifically to banks, and, in this respect, it is necessary to make a distinction between 'offshore' banking transactions in foreign currencies and the domestic employment of Euro-currency funds and inward switching. The Euro-currency business of banks consists in a large measure of the taking of deposits denominated in foreign exchange (to some extent from local sources but mainly from abroad) and the re-lending of these funds, without conversion, mainly to foreign institutions or non-residents. Generally, these external operations are free from any national exchange control regulations.

> *Even where selective techniques and guidelines have been used to regulate the banks' net foreign position (Canada, Denmark, France, Italy, the Netherlands, Sweden and, on occasions, Austria and Switzerland), the banks are left free to adjust their gross positions as they wish. Furthermore, foreign currency deposits are usually exempted from requirements and are not covered by regulatory and conventional interest rate limitations.*[33]

One country in which the authorities have often been moved to institute measures with the purpose of discouraging the taking of foreign currency deposits is West Germany which forbids the payment of interest on non-resident accounts generally (irrespective of currency) and requires certain minimum reserves. This is a somewhat exceptional case, and is, related to the unusual strength of the German mark, and the embarassment caused by the occasional massive inflow of 'hot' money. The transactions to which controls more generally apply are the switching in and out of local currency and the lending of foreign exchange to residents, since it is essentially these transactions which affect the domestic monetary situation. Occasionally, authorities with heavy foreign exchange reserves and excess liquidity may permit their banks almost complete freedom to switch out of domestic currency and to increase their foreign position in any currency. More often than not, however, controls are intended to prevent the outflow of domestic resources seeking a higher return in the Euro-currency markets, or to discourage the inflows which might hamper the attainment of national monetary objectives. In this context, measures employed include ceilings on banks' total net foreign assets, quantitative limits on banks' open exchange positions, bans on the payment of interest on domestic deposits owned by non-residents and reserve requirements on the non-resident liabilities of banks, to name a few.

To discourage inflows, reserve requirements can be imposed either on the gross or net foreign liabilities of the banks, depending on the range and priority of the objectives at any given time. Used in relation to the former aggregate, it is argued, this weapon will have the effect of discouraging "the bankers themselves from actively seeking foreign funds to expand their domestic lending, and neutralise at least part of any expansion in the deposit base initiated by foreigners".[34] Applied to net foreign liabilities there is the "added advantage of discouraging the banks from repatriating assets and encouraging them to match an inflow of foreign deposits with investments abroad".[35] A further technique which is sometimes employed in countries without any restrictions on inward and outward switching, is the provision of special swap facilities by national authorities with the purpose of encouraging inflows and outflows which can be induced to respond to guaranteed forward cover rates. If the authorities wish, for example, to control liquidity and reduce external reserves by encouraging the outflow of funds, they can sell foreign currency to the banks at spot rates and buy it back at rates sufficiently favourable to offset any interest rate differential in favour of employing funds at home rather than abroad. This obviously, is a costly operation since the central bank is normally committed to re-purchasing the foreign currency in the future at a higher rate than that at which it sold, and for this reason the technique tends to be employed very sparingly, particularly in view of the abuse to which it can also be put by the banks for profiteering purposes.[36]

The Framework of Control in the Bahamas

Although the Bahamas is used as a centre by foreign banks for 'off-shore' Euro-currency operations, domestic activities are, to a large extent, insulated from the effects of the banks' involvement in this external business,[37] which we pointed out earlier, is largely of an intermediary nature. (A breakdown by currency of assets held by authorised dealers is given in Table 2.3). Under the exchange control regulations, residents are generally not allowed to hold foreign currency accounts. When such accounts are allowed, these are mainly for commercial purposes and are carefully regulated by the authorities. Investment in foreign securities can only be purchased through the medium of the investment currency market[38] and must be held to the order of an authorised agent in the Bahamas. Non-residents are not generally permitted to hold Bahamian dollar deposits, but even where this happens, such a situation is not related, in any way, to the foreign deposit business. The Bahamian dollar, it should be pointed out, is not used as a Euro-currency. As we saw earlier, currencies which are used for this purpose are mainly those of the develope nations, for which there are adequate exchange markets and which tend to be freely convertible.

As far as regulations pertaining to the operations of the banks are concerned, these are fairly well defined. The 'shell' banks which are designated 'non-resident' for exchange control purposes operate without restrictions in the external currency markets, no reference to the authorities generally being required. They are not, of course, allowed to deal in Bahamian dollars. Resident banks (i.e. banks doing local business) authorised to deal in foreign exchange may borrow foreign currencies (or accept foreign currency deposits) without limit for re-lending to non-residents. Lending of foreign currency to residents can be done, but only with the approval of exchange control on a case by case basis, there are also no stipulations in terms of interest (charged or paid) or reserve requirements on the external business of the banks. The critical area where controls apply is in the switching into and out of Bahamian dollars, which at the moment is governed by a quantitative limit, this being B$ ½ million either way (i.e. a long or short open position). In other words, the total foreign currency liabilities of every authorised resident bank should not at any time exceed its foreign currency assets by more than B$ ½ million (and vice versa), though, as indicated earlier, this requirement is sometimes flouted, particularly on the short side. Unlike the United Kingdom, it should be noted, where authorised banks are permitted to switch foreign currencies into sterling for domestic use without limit, the banks in the Bahamas are not required to cover spot sales of foreign exchange by forward purchases,[39] though in their own interest this is probably a normal practice.

Using limits on the foreign exchange positions of the banks as a means of controlling inward and outward switching can be extremely effective when enforced, and it is a very apt instrument in the context of the Bahamas where the ability of the authorities to absorb excess domestic liquidity may be considerably limited. In some countries, however, direct quantitative restrictions are either deemed inappropriate or ineffective and therefore more frequent resort is made to some of the other controls we described earlier. In the United Kingdom for instance, it has been found that while control of exchange positions has been quite successful in preventing undesirable outward switching, no limit is placed on inward switching, which is felt would be quite useless in a situation where sterling can be purchased by foreign banks and then deposited with banks in the U.K.[40]

Impact on Domestic Credit

For exchange control purposes, there can be no distinction between foreign currencies that flow through the Euro-system and those that enter the economy through traditional commercial channels. As we have pointed out, Euro-money is not a special type of money in any way different from national currencies, with its own exchange rate and legal tender status. The conversion effects of any currency into Bahamian dollars, whether the sums concerned originate in the Euro-market or not, are the same. While, therefore, the Euro-market exists with the domestic market as a parallel source of funds, the possible effects on the domestic credit system of an inflow of funds from the Euro-currency market are no different from those of an inflow stemming from an ordinary capital transaction.. In both cases, the initial impact is an increase in the liquidity of the system, downward pressure on interest rates and a positive effect on the balance of payments. An outflow, of course, would have the opposite impact. (The ultimate effect on the money supply we might point out, will depend on the policy of the Central Bank which can operate on the base to influence movements in a particular direction). From the point of view of monetary policy, it would appear that the administrative controls in the Bahamas, discussed earlier, are fairly adequate, though if the desired effects are to be achieved they would have to be rigidly enforced, and in this context it may be necessary to impose punitive measures as a disincentive towards their frequent impingement to the extent that this is deliberate. The controls themselves, being of a flexible nature, permit the authorities to use the Euro-currency market as an instrument of liquidity policy, by encouraging outflows when necessary and attracting inflows when domestic conditions warrant it. However, since this kind of exercise is often beset by problems relating to conflicts between internal and external objectives, we should perhaps pursue this point further.

Capital movements through the banking system tend to be essentially of a short term nature, responding to interest rate differentials and expectations regarding the external value of a currency. In the absence of controls, a higher rate of return in the domestic, than that prevailing in the external markets, would discourage outflows and induce the banks to deploy funds from the latter to the former, assuming, of course, where switching to local currency is involved, that the interest differential is greater or at least equal to the premium to be paid in the forward market where such transaction is undertaken to cover a spot sale of foreign exchange.[41] With the interest rate positions reversed, the flow would tend to be in the opposite direction as funds move abroad in pursuit of greater profit. As a factor influencing the movement of short term capital, interest rate policies can be used to attain both external and internal objectives. While, on the one hand, they are frequently employed to improve the balance of payments and increase the level of foreign reserves, they can also be used in attaining internal equilibrium by influencing the demand and supply of funds as a means of attaining certain economic objectives. There would be occasions, of course, when the use of interest rate policies for internal purposes tends to be in conflict with external goals, and in this context some writers have suggested that monetary policy be restricted to the latter while resorting to fiscal policy for domestic regulation.[42] In the Bahamas, where the scope for fiscal policy is highly limited, a heavy responsibility would seem to rest with monetary policy in attaining both internal and external equilibrium. This subject is discussed furter in Chapter 7.

A loan to a resident in foreign currency which is used without conversion to make payments abroad, or is employed abroad in any form, makes no contribution to an expansion in the domestic money supply. On the other hand, if the loan proceeds are converted for domestic use, or the bank sells the foreign exchange in return for local currency which is then made available to the public, there is an addition to the money supply. Since, as already pointed out, the authorities in the Bahamas regulate foreign currency lending to residents as well as the exchange positions of the banks, expansion or reduction of the currency supply through this means can take place only within very narrow limits without authorised sanction, and this, of course, would depend on the state of domestic liquidity. From what we have said above, therefore, it is clear that in the light of the regulations employed in the Bahamas, the existence of the Euro-currency market as a parellel source of funds for the banks does not in itself render monetary policy ineffective, as is often the case in some Western European countries which allow the banks to convert in and out without limit. More directly, it can be said that the authorities can pursue a fairly independent interest rate policy with respect to Bahamian funds which cannot move abroad without exchange control approval. However, where non-resident capital is concerned, local interest rates would have to be related to external rates, whenever the movement of such funds is seen as necessary in attaining domestic monetary or balance of payments objectives.

Banking Flows and the Balance of Payments

In practice, the distinction between short term and long term capital transactions, like the distinction between current and capital accounts, is very often an arbitrary one which can have significant implications for policy, in the context of the balance of payments. Short term capital movements, as a variable in achieveing external objectives, depends on the way it is treated in the calculations as they relate to monetary movements and the rest of the account. Thus, if short term flows are included in the former account, as was the case with the United Kingdom up until 1970, surpluses or deficits would not be affected by movements in this item. In most countries, however, the approach adopted is to derive net balances from both current and capital accounts (short and long), rather than use the latter as financing items, or ignore short term movements in the credit calculations.

The impact of Euro-currency transactions (which we indicated earlier are essentially short term flows)[43] on the balance of payments depends on the use to which funds are put by receiving banks (the authorised dealers).[44] A foreign currency deposit received from a non-resident and on-lent[45] to a non-resident has no effect on the balance of payments. The Bahamas' short term assets and liabilities are increased by the same amount. On the other hand, a non-resident deposit which is on-lent to a resident for purchases abroad or for domestic investment results in a capital inflow, and since, this is not offset by a corresponding outflow, there is a net addition to the Bahamas short term liabilities. It should be noted, however, that where the loan is made in foreign currency, which is subsequently spent abroad, there would be a corresponding reduction in external assets. Where the funds are changed into local currency for domestic use, there would be a temporary gain in reserves until the loan is repaid.

Compiling balance of payments data in the Bahamas is a relatively new exercise which is still in the process of evolution as the official authorities intensify their attempts to improve the quality of the statistics obtained from the relevant institutions. In this effort, new reporting forms, as indicated earlier, were introduced by the Central Bank at the beginning of 1974, and these represent a significant improvement over those used prior to this date, which paid little attention to the delineation of financial institutions' foreign assets and liabilities from other items in the balance sheet. For this reason, it is difficult to get an accurate picture of the impact on the balance of payments of short term capital movements through the banking system in the period up to 1974. Based on the new reporting forms some estimates have been made of this particular item in recent years and these are presented in Table 5.6.

Even these figures, it should be noted, are treated as being of a very tentative nature. On the whole, the private capital account of the balance of payments leaves a great deal of room for improvement. At the moment, surpluses and deficits in the balance of payments tend to be measured in terms of changes in official reserves. In trying to assess the effects of banking on the balance of payments, an obvious problem that arises is whether or not one should take account of the Euro-currency business of the commercial banking system, which, as we have seen, has little to do with economic activities in the Bahamas. If we regard both the local and the foreign currency operations at the base of making calculations a critical question that arises in how does such a procedure affect a proper portrayal of the

TABLE 5.6

NET CAPITAL MOVEMENT EFFECT OF AUTHORISED BANKS ON THE BALANCE OF PAYMENTS, 1974 TO 1978

Year	$ Million
1974	+18.0
1975	–11.4
1976	–23.5
1977	+27.5
1978[a]	–4.3

a: Provisional.

Source: Central Bank of the Bahamas, *Quarterly Review* various issues.

country's external performance and position. In this connection, an important point to note is that the effort to achieve a correct measure of the net monetary movements attributed to the banking system is no easy matter in the context of the web of transactions that takes place between local institutions, and between the latter and foreign based operators. However, even if this exercise can be carried out with some degree of accuracy, large fluctuations in the Euro-currency accounts are bound to swamp movements in the figures reflecting developments in B$ activities which is the area of major concern to the local authorities. In this connection, it is worth noting that although it is possible to construct balance of payments accounts that may be correct from a statistical point of view, there are likely to be serious limitations in their use as a basis for policy decisions, if the implications of the underlying conceptualisation are not fully understood. So long as the banks keep one set of books and so long as they regard the local and foreign operations as inseparable, there are going to be grave difficulties in constructing proper external accounts, which could inform and guide local policy making.

The decision of the authorities up to now as they relate to monetary matters have been influenced largely by the level of official foreign reserves, and in this context the inability to ascertain with some degree of precision the net foreign asset position of the private financial sector has no doubt been a constraint on policy formulation. Compilation of the balance of payments accounts is much more than a statistical exercise of historical interest, and this fact must be firmly impressed on the institutions concerned, some of whom still find difficulty in providing data that conform to the particular concepts underlying the statistical framework being used.

In closing, it should be pointed out that even in respect of long term capital flows, the statistics are either unavailable or of a very poor quality, and this has to be attributed, in large measure, to the lack of a proper data gathering system in the exchange control division of the Central Bank. Such an undertaking will also be of considerable assistance in cross-checking some of the figures, obtained directly from financial institutions, relating to inflows and outflows of funds of both a current and capital nature.

Concluding Observations

Banks in the Bahamas can be divided broadly into two groups. One category consists of institutions (the authorised dealers) that are involved both in the local and the foreign currency business. The other comprises organisations (some with a physical presence) whose orientation is exclusively external. The latter group, which for exchange control purposes is designated non-resident, is not included in the banking and balance of payments statistics. While the authorised dealers do not keep separate ledgers for their domestic and foreign business, the framework of control attempts to preserve a delineation, both for statistical and policy purposes. The foreign exchange regulations are generally very straightforward and this forms the pivot for other administrative rules and directives. The fact, of course, that the Bahamas dollar is not a Euro-currency makes the situation less complex than those of countries whose currencies are bought and traded within a framework based on convertibility. In the latter case, a wider range of regulations is needed to isolate national monetary policies from the influences of the international currency business. Access to Euro-currency funds, however, by banks in the Bahamas, does reduce the force of conventional monetary instruments, even though, as we indicated, the exchange regulations represent a very potent form of control.

FOOTNOTES

1. It is estimated that banks in London (British and London based foreign banks) account for more than 50 per cent of the total (world) Euro-dollar operations.
2. See Morgan Guaranty Trust, *World Financial Markets,* March, 1979, p. 15.
3. See Paul Einzig, *The Practice and Theory of International Interest Rates, the Euro-dollar System,* 5th ed. New York, St. Martins Press, pp. 3–5.
4. See Morgan Guaranty, *op., cit.,* p. 5.
5. This is not a special type of bank. The term is used in reference to ordinary financial institutions which participate in Euro-currency activities.
6. It should be noted, however, that Euro-banks' income is not limited to net profit from loan activities. A significant share of their profits is made from additional business which flows from the initial loan. (See D. Altman, "Foreign Markets for Dollars, Sterling and Other Currencies", *IMF Staff Papers, 1960–61).*
7. See E. Wayne Clendenning, *The Euro-dollar Market,* Oxford, Clarendon Press, 1970 , p. 2.
8. B.I.S., *34th Annual Report,* p. 127.
9. B.I.S., *36th Annual Report,* pp. 145–6.
10. P. Einzig, *op., cit.,* p. 207.
11. Fred Klopstock, "Euro-dollars in the Liquidity and Reserve Management of United States Banks", *Essays in Domestic and International Finance,* New York, Federal Reserve Bank, 1969 , p. 72.
12. P. Einzig, *op., cit.,* p. 11.
13. Not however, the country with the largest number of foreign bank offices – a distinction held by the United Kingdom.
14. These figures include local currency assets. The amount involved however, would be insignificant compared to foreign currency claims.
15. This was the proposed date. The tax did not pass into law until September, 1964, though the effect was made retroactive to the date of announcement.
16. There were a number of circumstances under which this limit could be exceeded, e.g. to fulfil binding commitments made prior to the introduction of the VFCR or to furnish bona fide export credit.
17. For purposes of this programme all foreign countries (with the exception of Canada) were divided into three categories:

    (1) Schedule A countries consisted mainly of the developing nations.

    (2) Schedule B countries included certain specific nations such as Britain, Australia, New Zealand, Japan and the Middle East oil-producing countries.

    (3) Schedule C countries consisted of the developed nations of Western Europe, the Socialist Bloc and South Africa (including South West Africa).

    The annual limit imposed on investors with interest in Schedule A countries was 110 per cent (of 1965–66 average direct investment figure), 65 per cent for those investing in B nations and 35 per cent for investors interested in C countries.
18. In September, 1969, Euro-dollar borrowings were made subject to reserve requirements.
19. Fred H. Klopstock, "Euro-dollars in the Liquidity and Reserve Management of United States Banks", *Essays in Domestic and International Finance,* Federal Reserve Bank of New York, 1969.

20. This, of course, can only be done with the approval of the Federal Reserve Board which view this technique as one way of getting around the competition faced by the small and medium-size banks who cannot afford full-service overseas offices.

21. Douglas Hayes, *Bank Lending Policies: Domestic and International*, Michigan, Bureau of Business Research, Graduate School of Business Administration, University of Michigan, 1971, p 221.

22. Central Bank of the Bahamas, *Quarterly Review,* June 1974, pp. 15–16. Expenditure details for one small Euro-dollar ('shell') bank at the end of 1973 were given as follows:

Licence Fee	B$2,004
Manager Fee	1,000
Audit Fee	178
Legal Notice	128
Sundry	46
Total	**B$3,356**

23. Charles S. Ganoe, "Nassau Branches", *Journal of Commercial Bank Lending,* December, 1970.

24. *Ibid.*

25. Those and other advantages are discussed in some detail by Alan Teck (Assistant Vice President, Chemical Bank), in "The Future of Limited Services Branches in Nassau", *Euro-money,* January, 1973.

26. *Ibid.*

27. *Ibid.*

28. Bermuda, as we indicated in an earlier chapter, has all the necessary attractions but keeps a very strict control on the number of banks allowed to operate in the country or from within its shores. There are only about four banks there.

29. Permits granted banks and trust companies are divided into two groups, viz. 'A' licence and B' licence. Institutions in the former category can carry on business both within and outside the Cayman Islands, while companies in the latter group can only do business with people outside the Caymans.
Licences are further sub-divided into 'restricted' and 'unrestricted'. The bank or tust company applying for an 'unrestricted' licence, which places no restrictions on the holder in terms of the people with whom it does business, is required to have a paid-up capital of at least US $250,000. While the comparable figure is only US $25,000 for the 'restricted' category, holders of such licences can only solicit or receive funds from persons or companies specified in the permit at the time at which it is granted.

30. C. Ganoe, *op., cit.,*

31. See Special Survey, p. 17 of the *Economist,* January 27, 1973.

32. *Ibid.*

33. M. Gilbert and W. McClam, "Regulations and Policies Relating to the Euro-currency Market" in H.V. Prochnow, ed., *The Euro-dollar* (Chicago: Rand McNally & Company, 1970), p.362.

34. The *Economist's* Survey, *op., cit.*

35. *Ibid.*

36. *Ibid.* See also R.E. Caves and R.W. Jones, *World Trade and Payments* Boston, Little, Brown and Company, 1973, p. 518.

37. It should be pointed out, however, that the banks generally do not keep separate ledgers.

38. As a developing country the Bahamas finds it necessary to exercise very strict control over the use that is made of foreign exchange earnings. Since capital funds are needed at home, investment in foreign securities is not encouraged. Such transactions, however, are not altogether probibited. The Investment Currency Market refers to an approved arrangement which permits residents ,to acquire foreign currency for the purchase of foreign securities or real estate by paying a 'premium'. The supply of investment currency originates with residents holding assets abroad, and the amount available at any moment in time tends to depend on the state of the foreign security and real estate markets. The level of the premium, of course, is influenced by demand and supply factors.

39. The British banks are allowed a small uncovered position.

40. See M. Gilbert and W. McClam, *op., cit.*

41. Using an adaption of R M. Stern's illustration pp. 43–44 of *The Balance of Payments,* Chicago, 1973, the condition of interest parity can be expressed algebraically as follows:

The two countries used in the illustration are the Bahamas and the United Kingdom.

r_s – the current spot rate of exchange; the dollar price of one pound delivered today.

r_f – the current 1 year forward rate of exchange; the dollar price today of one pound to be delivered in 1 year.

p – $(r_f - r_s)/r_s$, the forward premium of discount expressed as a percent of the spot rate of exchange.

i_a – average 1 year interest rate yield in the Bahamas.

I_e – average 1 year interest rate yield in the U.K.

Thus, \$1 invested in the Bahamas for 1 year would become \$1 $(1 + i_a)$. If converted into pounds at the spot rate of exchange and invested in the U.K. this would yield \$1 $(1 + i_e)\, r_s$.

If this latter amount were converted back into B\$ at the presently quoted 1 year forward rate, it would become \$1. $r_f\ (1 + i_e)\ r_s$. Short term funds would therefore move from the Bahamas to the U.K. if:

$$\frac{r_f\,(1 + i_e)}{r_s} > (1 + i_a) \tag{1.1}$$

Alternatively, funds would move from the U.K. to the Bahamas if:

$$(1 + i_e) < \frac{r_s\,(1 + i_a)}{r_f} \tag{1.2}$$

The equilibrium condition of interest parity will be obtained when:

$$\frac{r_f\,(1 + i_e)}{r_s} = (1 + i_a) \tag{1.3}$$

Expressing r_f/r_s as $1 + p$, where p is the forward premium if positive, and the forward discount if negative, equation (1.3) can be written as:

$$(1 + p)\ (1 + i_e) = (1 + i_a) \tag{1.4}$$

Since both p and i_e are generally small decimals, their product may be considered to be of the second order of smalls. In this case, equation (1.4) reduces to:

$$p = i_a - i_e$$

which is the conventional formulation of the equilibrium condition for interest parity.

42. See, for example, Robert A Mundell, "The Appropriate Use of Monetary and Fiscal Policy for Internal and External Stability", *IMF Staff Papers,* Vol. IX, 1962.

43. While the discussion is confined to capital movements, it should be noted that commissions and interests received and paid by authorised dealers also affect the balance of payments.

44. For a general but useful discussion the implications of Euro-currency transactions for a domestic financial system See E Wayne Clendenning, *op., cit.,* pp. 151–161.

45. Even where the deposits are taken in one foreign currency and converted into another foreign currency for on-lending, this will have no impact on the Bahamas balance of payments. All that will have resulted from such a transaction is a change in the foreign currency portfolio of the bank.

CHAPTER 6

CURRENCY ARRANGEMENTS AND THE SCOPE FOR MONETARY POLICY IN THE BAHAMAS

Currency History from 1900[1]

Proximity to the United States and the general openness of the economy, made possible by the geographical structure of the Bahamas and the nature of its main economic activities, have always encouraged a certain amount of American currency to circulate locally. Estimates of the volume of such currency in circulation do not exist for any period in the country's history prior to 1970[2] and it is therefore difficult to formulate accurate figures for the total supply of currency in this period. The problem is made even more difficult by the absence of comprehensive data on British currency which formed an overwhelming part of the currency in circulation in the first three or four decades of the century. Some surviving Colonial Office Reports, however, do furnish us with fragmentary information relating to the main monetary assets in existence in the period from the turn of the century to more recent times.

British sterling money was declared to be the colony's money of account in 1838.[3] By 1900, in addition to the British silver and copper coins in circulation, exchange transactions were being faciliated by some United States gold,[4] particularly in the southern islands of the colony, and a small amount of U.S. silver,[5] both of which had legal tender status. Also in circulation were Spanish, Mexican and Columbian gold doubloons[6] which remained on the scene until the mid-1920's, also as officially recognised money. (Estimates of the amount of coin of all variety in circulation between 1900 and 1940 are provided in Table 6.1).

With the establishment of the Bank of Nassau in 1888, these assets were supplemented by the first local paper currency (made up of 4/—and £ notes) which gradually increased to reach £6,500. Around this time, American silver dollars which were being exchanged (by proclamation) at half a dollar for two shillings, and a quarter of a dollar for one shilling, also began to be accepted by the Bank of Nassau at their face value in the U.S. and re-channelled into general circulation. This decision was reportedly precipitated by the frequent shortages of British silver which was being hoarded or shipped out of the Colony to America and Jamaica by an unscrupulous merchant.

By the outbreak of the First World War, several developments affecting the currency supply had taken place. In addition to British silver and copper coins which formed the bulk of the currency in circulation, U.S. gold and

TABLE 6.1

ESTIMATES OF AMOUNT OF COIN IN CIRCULATION, 1900 TO 1940

Year[a]	£	Year[a]	£
1900	40,000	1927	50,000
1913	40,000	1929	40,000
1915	40,000	1930	65,000
1920	55,000	1931	55,000
1921	50,000	1932	50,000
1923	60,000	1933	50,000
1924	50,000	1934	25,000
1925	50,000	1936	25,200
1926	30,000	1940	24,986

a: Ending 30 November.

Source: Colonial Office, *Blue Books.*

silver certificates, while not legal tender, were also being accepted, subject to certain conditions. For $5 and upwards the rate applied was the same as that of U S. gold, and if below $5, the rate was 4s. to the dollar. During the war years, British Treasury Notes (£1 and 10s.) had also entered the currency stream. In the space of one year, between 1916 and 1917, the total value of these notes in circulation increased from £16,000 to £30,000. In subsequent years, a number of Bank of England notes also found their way into the colony. In 1936, there were £2,000 worth of such notes in circulation.

The period after the First World War witnessed the introduction of local government notes which supplemented rather than replaced the pre-war currencies in circulation. The decision to issue local notes was, to a large extent, motivated by the withdrawal of the notes of the Bank of Nassau which went out of operation in 1917.[8] Rising economic activity in the Colony following the end of the war and the increasing demand for currency provided an additional incentive. Even with the issuance of local notes, however, British currency continued to be 'current coin' in the Colony until 1 November, 1936 when sterling silver ceased to be legal tender in the colony for the payment of any amount exceeding 40s.[10] American currency, too, continued circulating side by side with the local medium — a practice that has continued into the present day, even though residents are required to turn in foreign currency to the authorised dealers[11]

THE CURRENCY BOARD SYSTEM

Legislation providing for the issue of local Government notes was first introduced into the Bahamas in 1919 in the form of the Currency Note Act[12] which laid the foundations of a monetary system that was to serve the Bahamas for almost half a century. The arrangements introduced by this law were modelled, in important respects, on the West African Currency Board System which was set up in 1912 as a result of the report of the Emmott Committee appointed in 1911 by the Secretary of State to inquire into "matters affecting the currency of the British West African Colonies and Protectorates".[13] Although the system set up by the 1919 legislation was to receive a new legal basis in the Currency Note Act of 1936, which itself was slightly amended on two occasions, the mechanisms introduced by the earlier law were to remain virtually intact until 1965 when a fundamental departure was made from traditional policy.

The Currency Board arrangements, as a standard method of regulating currency operations in British colonial territories,[14] have been widely discussed in the literature.[15] In order, however, to better understand the implications of recent monetary developments in the Bahamas, we shall, in the next few paragraphs, outline the essentials of the system and this will be followed by a brief discussion of the major arguments that have been advanced for and against it.

The operations envisaged in the Currency Board legislation were essentially very straightforward. The main feature of the system was that the Board issued local currency in exchange for sterling deposit in London on a one to one relationship and stood ready to redeem its local liabilities on the same basis (a small commission, usually one quarter to half per cent being involved in these transactions in both directions).

> *The Commissioners shall issue on demand to any person desiring to receive currency notes in the Colony, currency notes to the equivalent value (at the rate of one pound sterling) of sums in sterling,[16] lodged with the Crown Agents in London by the said person, and shall pay on demand through the Crown Agents to any person desiring to receive sterling in London the equivalent value calculated as aforesaid of currency notes lodged with them in the Colony by the said person. . .*[17]

To meet its exchange obligations, the Board was required under the regulations to hold minimum sterling reserves to the value of 100 per cent,[18] of its currency liabilities[19] (See table 6.2). These reserves, it was further specified, were not to be put at the disposal of the local government. "The Note Security Fund shall be held by the Crown Agents and may be invested in securities of, or guaranteed by, the Government or any part of the British Empire (except the Government of the Colony) or such other

TABLE 6.2

STERLING ASSETS AS A PROPORTION OF THE CURRENCY NOTE ISSUE, 1921 TO 1968

Position at	(1) Currency Note Issue £	(2) Sterling Investments[a] £	(3) Coin Portion of Note Guarantee Fund £	(4) (2) + (3) £	(5) (4) as a % of (1)
10/11/21	3,800	1,170	2,800	3,970	104.5
10/11/22	3,800	1,170	2,900	3,970	104.5
10/11/23	39,885	14,285	26,687	40,972	102.7
10/11/24	60,000	43,728	20,000	63,728	106.2
10/11/25	60,000	43,728	20,000	63,728	106.2
10/11/26	100,000	71,820	33,333	105,153	105.1
10/11/27	110,000	80,476	36,667	117,143	106.5
10/11/28	110,000	80,476	36,667	117,143	106.5
10/11/29	110,000	80,476	36,667	117,143	106.5
16/12/30	110,000	81,471	36,667	118,138	107.4
10/12/31	110,000	81,471	36,667	118,138	107.4
10/12/32	110,000	81,508	36,667	118,175	107.4
10/ 1/33	110,000	81,508	36,667	118,175	107.4
13/10/34	110,000	81,253	36,667	117,920	107.2
			Sterling Cash[b]		
10/11/34	73,400	81,996	67	82,063	111.8
12/11/35	73,400	87,545	67	85,612	116.6
10/10/36	73,400	88,704	67	88,771	120.9
10/ 9/37	73,400	94,965	67	95,032	129.5
10/ 8/38	79,400	75,488	6,838	82,326	103.7
8/ 8/39	92,000	96,999	140	97,139	105.6
31/12/40	136,220	130,834	11,033	141,867	104.1
31/12/41	176,620	156,276	28,690	184,966	104.7
31/12/42	252,020	147,290	115,344	262,634	104.2
31/12/43	350,370	221,928	145,342	367,270	104.9
30/12/44	374,970	232,651	164,552	397,203	105,9

TABLE 6.2

STERLING ASSETS AS A PROPORTION OF THE CURRENCY NOTE ISSUE, 1921 TO 1968 (CONTINUED)

Position at	(1) Currency Note Issue £	(2) Sterling Invest-ments[a] £	(3) Coin Portion of Note Guarantee Fund £	(4) (2) + (3) £	(5) (4) as a % of (1)
31/12/45	355,150	257,145	123,422	380,567	107.1
31/12/46	482,800	303,926	216,072	519,998	107.7
31/12/49	637,400	525,471	170,694	696,165	109.2
31/12/50	663,800	561,552	172,657	734,209	110.6
31/12/51	775,600	667,154	124,769	791,923	102.1
31/12/54	976,500	1,030,063	33,487	1,063,550	108.9
31/12/55	1,126,500	926,563	197,755	1,124,318	99.8
31/12/56	1,406,500	1, 165,017	210,243	1,375,260	97.8
31/12/57	1,641,500	1,221,104	402,993	1,624,097	98.9
31/12/58	1,742,900	1,464,478	347,422	1,811,900	103.9
31/12/59	2,106,800	1,623,359	590,426	2,213,785	105.0
31/12/60	2,286,300	1,982,927	279,764	2,262,691	98.9
31/12/61	2,146,300	2,059,230	163,373	2,222,603	103.6
31/12/62	2,529,300	2,342,574	382,232	2,724,806	107.7
31/12/63	2,950,000	2,008,928	1,027,000	3,035,928	102.9
31/12/64	3,349,900	2,871,920	787,898	3,659,818	109.2
31/12/65	3,904,500	3,296,713	828,771	4,125,484	105.6
3/12/66	13,199,000	7,126,286	2,365,333[c]	9,491,619	71.9
31/12/67	18,749,500	3,480,337	8,869,354[d]	12,349,691	65.9
31/12/68	25,784,728	n/a	n/a	18,144,055	70.4

Notes: a: The figures for the years between 1921 and 1933 refer to the nominal value of the securities held. For the period thereafter the latest known market value is given. The Security Fund was calculated on the latest known market price for the securities held.

b: Comprises local cash balances, remittances to Crown Agents for investment and deposits with Joint Consolidated Fund.

c: U.K. sterling cash on deposit with the Royal Bank of Canada for investment.

d: Comprises demand and time deposits in US dollars and sterling.

Source: *The Gazette,* various issues.

securities as the said Crown Agents, with the approval of the Secretary of State, may in their discretion select. . ."[20]

As can be seen from the modus operandi described, the Board was essentially a money-changer buying and selling local notes in exchange of sterling with which they were freely convertible at a fixed rate of exchange. Hence the reason why the system is sometimes referred to as the Sterling Exchange Standard. Operations were entirely passive since the Commissioners had no discretionary powers, and the currency supply was thus uniquely determined by the balance of payments. It should be noted that the term 'currency supply' and not 'money supply' was used; for if the latter is defined to include bank deposits, which can also act as a medium of exchange, then the policy of the commercial banks becomes a critical factor in the determination of this aggregate on which the direction of change would depend on the type of response by the banks to a change in reserves.[21] Another element that comes into play in a situation where banks exist is the public's preference as between currency and deposits, which can also influence the ability of the banking institutions to create credit (see chapter on Commercial Banking).

Thus, although in practice there was some flexibility in the system, in so far as the money supply was concerned, (as distinct from the currency supply) "this flexibility was accidental in the sense that it was achieved by a number of decisions by different people that were more or less independent of each other".[22] With respect to monetary management, the arrangements by virtue of the rigid links with the balance of payments allowed the authority no scope for manipulating the money supply in stabilisation policy or in adjustments necessitated by national income and population growth, and this was, undoubtedly, one of its greatest shortcomings. Defenders of this aspect of the system, however, argue that the rigid currency/sterling relationship stipulated in the regulations removed the possibility of over-issue induced inflation, from which, it should be pointed out, the colonial territories were by no means insulated since abnormal increases in prices can easily be generated by other structural factors. In fact, as one writer observes, expansion of the currency is often an effect rather than a cause of inflation.[23]

Another major criticism levelled at the colonial currency arrangements stemmed from the 'cost' involved in maintaining 100 per cent reserve backing for the local currency. Under any currency system associated with an open economy, it is necessary for the authorities to maintain a certain level of foreign exchange for facilitating external payments. Since at no time, however, is it likely that all holders of currency will simultaneously try to exchange local currency for sterling or other foreign currencies, maintaining 100 per cent reserve backing would clearly seem to be a luxury that developing countries could ill afford. The implication of such a situation was that resources which could be used to develop the country were put at the disposal of the British and other Commonwealth Governments, while the local economy was often at the same time suffering from a shortage of capital funds, in some cases having to resort to foreign borrowing to meet local needs.

Another argument one often hears in defence of the system was that the fixed relationship[24] between the local currency and sterling and its automatic convertibility to the latter, was an important factor in encouraging private capital inflows from the metropole to the colonies, given the absence of exchange risks and the ability to repatriate profits inherent in the arrangements. While there is, undoubtedly, some truth in this, there is the counter view that such a relationship tied the fate of the local currency to sterling, and that any change in the external value of the latter vis-a-vis other currencies meant an automatic change in the former. The 1967 devaluation brought out in dramatic form the dangers inherent in this situation. It also needs to be pointed out that the movement of long term capital often tends to be influenced more by such factors as the desire to preserve or capture a market, the availability of scarce natural resources, cheap labour etc., than by the stability of the exchange rate system.[25]

The main features of the Currency Board System, as originally established in the Bahamas, continued in operation until 1965 when the first significant change was made. The Currency Act of that year which was intended to give effect to the decision to decimalise the currency by the introduction of the Bahamian dollar (originally pegged at 7 shillings sterling)[26] reduced the currency backing to 50 per cent of "the face value for currency notes issued by the Commissioners and for the time being in circulation". As can be seen in Table 6.2, while in the years following 1965 the ratio of foreign reserves to local currency did drop significantly, it never quite reached the legal minimum of 50 per cent. In fact, as we shall see later, after the establishment of the Bahamas Monetary Authority in 1968, the proportion often climbed to pre-1965 levels and frequently exceeded them, although the 50 per cent legal minimum was still in effect.

Another important change brought to the currency arrangements by the 1965 Act was the provision that the currency reserves could be held in gold, sterling or U.S. dollars, subject to the direction of the Minister of Finance.

> *The Currency Security Fund shall be held by the official bankers or by the Commissioners of Currency in the name or to the order of the Government of the Bahama Islands and may, subject to the general or specific directions of the Minister, be held or invested by them in any of the following, that is to say —*
>
> *(a) gold coin or gold bullion;*
>
> *(b) sterling notes, sterling coin, bank balances and money with official bankers;*

(c) balance in a bank in any part of the Commonwealth outside the Colony, whose currency is freely convertible into sterling or in the United States of America, and notes, coins and money at call;

(d) Treasury bills maturing within one hundred and eighty-four days issued by the Government of any part of the Commonwealth outside the Colony, whose currency is sterling or is freely convertible into sterling or by the Government of the United States of America; or

(e) securities issued or granted —

(i) by the Government of any part of the Commonwealth outside the Colony, whose currency is sterling or is freely convertible into gold or sterling, or by any local authority in any such part of the Commonwealth which are by the law of such part authorised for the investment of trust monies;

(ii) by the Government of the United States of America or other securities issued in the United States of America which by any law in force in that country are authorised for the investment of trust monies.[27]

Despite this freedom in the powers of investment, the devaluation of 1967 caught the Government holding the bulk of its foreign exchange in sterling, though the country's commercial relationships with the United States, while always strong, had taken on considerably greater significance by this time. In the years immediately following this event, the country continued to hold a large part of its foreign assets in sterling, as a result of the Sterling Area Agreements in which the British Government undertook to guarantee the U.S. dollar value of the reserves[28] if a certain minimum proportion of official holdings was maintained in sterling. Under the initial agreement which was signed on 20 September, 1968 for three years, the agreed minimum sterling proportion (M.S.P.) was 80 per cent. This percentage was reduced to 72 per cent in the second agreement signed in late 1971 for a period of two years, at the end of which the Bahamas authorities agreed to a further extension of six months, though under a slightly different arrangement. At the end of the final agreement which covered the period April to December, 1974, the authorities embarked on a programme of gradually running down their sterling balances, which at the end of 1978 amounted to less than 10 per cent of total monetary reserves. Over 80 per cent were in U.S. dollars.

THE BAHAMAS MONETARY AUTHORITY

As a result of the country's own fiscal arrangements and innovations in international banking and finance practices, the 1960s saw the Bahamas emerge as an important financial centre which brought with it, not unexpectedly, a more complex range of administrative problems for the local authorities. This, coupled with the sterling devaluation of 1967, which had a kind of shock effect on Sterling Area members who had come to regard the external value of the British Pound as almost immutable, impelled the Bahamian Government into taking a closer look into its own internal monetary arrangements, and the future relationship of the Bahamian dollar to Sterling to which it was pegged. "A lesson dramatically brought home by devaluation . . . was the realisation that the United Kingdom, as a result of its own chronic balance of payments deficit, could endanger the economy of any territory such as that of the Bahamas, notwithstanding that the balance of payments of that territory had shown an overall surplus position for many years."[29] Also brought to the consciousness of the local administration was the fact that there was a chronic lack of statistical data for purposes of informing policy decision.

> *Already, before devaluation became a stark reality it was realised that the figures provided by the major banks each quarter to the Government for submission to the United Kingdom for statistical purposes, were of little value. For instance, those figures included only one figure for 'Deposits' be they deposits in Bahamian dollars, in pounds sterling, in U.S. or Canadian dollars, or for that matter in any other currency. It was not until after devaluation, however, that it was discovered that several of the banks themselves could not readily ascertain what portion of their sterling deposits was due to residents of the Bahamas and what portion was due to residents of other parts of the sterling areas.*[30]

These questions plus the fact that the exchange control regulations (which play a critical role in regulating the inflow and outflow of money into and out of the country) had grown increasingly complex over the years, demanded a much more coordinated and deliberate approach in dealing with problems relating to the monetary and financial administration of the economic system. In this context, the Government, in early 1968, invited to the Bahamas a Bank of England official (Mr. S.W. Payton) to look into the possibility of setting up a monetary institution that would perform certain specified functions. The terms of reference as set out in the first two paragraphs of his report[31] were as follows:

> *The Government of the Bahamas invited me to Nassau to advise on the desirability of establishing a monetary authority which 'would inspire confidence in the Bahamian dollar and encourage banking activities*

and further investment in the Bahamas.'

It was thought that the function of the authority would include the issue and redemption of currency; the custodianship of international reserves; the role of fiscal agent, including the administration of Government funds and the management of the Public Debt. It would issue, buy and sell Treasury Bills and Government securities and be responsible for the inspection of banks and other financial institutions and administer exchange control.

As can be seen, while the intention was clearly to set up an institution with a broader range of functions than that performed by the Currency Board, an organisation with full central banking control instruments was not envisaged. Payton himself, after examining the then prevailing situation, concluded that "a monetary authority conducting banking operations for the Government and banks and attempting to develop money and capital markets and regulate the money supply is unlikely to be effective. . ." He did not, however, rule out the Central Bank as a future possibility, arguing that "it is appropriate for the foundations of a monetary organisation to be laid so that they can be built upon as the need for more elaborate operations become apparent". This sentiment was echoed by the Government in the penultimate paragraph of the White Paper cited earlier. "It is important to note that the proposed Monetary Authority will not be a full-fledged Central Bank with all the usual powers of that institution. It is anticipated, however, that it will be set up in such a way as to extend its activities as and when the economy of the country warrants other steps to be made".

The Bahamas Monetary Authority (BMA) was set up by Act No. 27 of 1968 which was assented to on 23 October of that year. The authorised capital of the organisation which was established as a body corporate having perpetual succession and fully owned by the Government, was set at B$ 3 million dollars, of which B$ 0.2 million was to be paid-up. The policy of the Authority and its general administration was entrusted to a Board of Directors which comprised a Chairman (who was supposed to be "a person having, in the opinion of the Minister (of Finance) an established reputation and experience in banking and monetary matters") and five other directors, two of whom were also to be appointed by the Minister of Finance on the basis of their "knowledge and experience of the economy of the Bahamas Islands" while the three others viz. the Permanent Secretary to the Ministry of Finance, the Superintendent of Banks and the Manager were to be directors ex-officio.

The purpose of the institution as eventually emerged was outlined in Section 5 of the Act and read as follows:

(a) to issue and redeem notes and coins;

(b) to supervise the banks and trust companies operating in or from within the Bahama Islands;

(c) to foster close relations between the banks and the Government;

(d) to advise the Government on banking and monetary matters;

(e) to administer exchange control on behalf of the Government; and

(f) to perform such functions as may be necessary to fulfill the aforesaid objects.

An examination of the above objects reveals that essentially, what the Act did, was to bring together, under one body, a number of related functions hitherto performed by different government agencies and departments and which could no longer be effectively carried out in isolation from each other. The intention in setting up the BMA, however, went a little beyond this, as can be seen in objects (c) and (d) which assigned to it a very special role in the context of the growing complexity of the financial system and the increasing responsibilities of the government sector which needed to keep internal and external monetary developments under constant review. Collecting and analysing data from the financial community thus became an integral part of the functions of the Authority in the capacity as adviser to the Minister of Finance on monetary and banking policy. As part of this responsibility, it was also necessary for the institution to assume responsibility for the construction of balance of payments data in order to monitor the external position of the country on a continous basis.

In order to carry out its functions, the Authority was equipped with a range of powers which were set out in Section 26 of the Act. These included, inter alia, the power to

(a) purchase and sell gold coin and bullion;

(b) purchase, sell, discount and rediscount Treasury bills of the Government forming part of a public issue and maturing within ninety-three days;

(c) purchase and sell publicly issued securities of, or guaranteed by, the Government maturing in not more than twenty years;

(d) purchase and sell foreign currencies and purchase, sell, discount and rediscount bills of exchange and Treasury bills drawn in or on places abroad and maturing within one hundred and eighty-four days (exclusive of days of grace) from the date of acquisition;

(e) purchase and sell securities expressed in the currency of any country outside the Bahama Islands whose currency was sterling or was freely convertible into gold or sterling and either issued or guaranteed by the Government of such country or authorised for the Government of trust moneys by any law in force in such country (hereafter in this section referred to as "specified securities");

(f) borrow from any bank or financial institution any foreign currency which the Board, after consultation with the Minister of Finance, might have thought expedient to acquire;

(g) undertake the issue and management of loans publicly issued in the Bahama Islands by the Government or by any public body;

(h) receive deposits from banks;

(i) grant loans and advances to banks for fixed periods not exceeding six months on the security of all or any of the following:

  (i) gold coin or gold bullion;

  (ii) Treasury bills of the Government;

  (iii) securities issued or guaranteed by the Government;

  (iv) specified securities.

  Provided that a loan granted on any such security as is mentioned in this paragraph did not exceed seventy-five **per centum** of the current market value of that security.

Prohibited activites included –

(a) engaging in trade or having a direct interest in any commercial, agricultural, industrial or other undertaking except such interests as the Authority might have acquired in the course of the satisfaction of debts due to it. These latter, however, were to be disposed of at the earliest suitable opportunity;

(b) the purchase of shares of any corporation or company including the shares of any banking company;

(c) the making of loans to any person except where such loans were to officers of the Authority for the purchase of a residence on a secured basis;

(d) the purchase, acquisition or lease of real property except as might have been related to the provisions for premises or to residences of officers or other similar purposes.

Under the legislation, the Authority was given sole right to issue, reissue and redeem notes and coins in the Bahama Islands. Although under Section 12 it was obliged to issue and redeem local currency against sterling on demand (subject, of course, to certain conditions), a notable innovation of the currency arrangements was the linking of the Bahamian dollar to gold instead of to sterling as was traditionally done. Although this meant that the automaticity was legally broken in practice, as was pointed out earlier, the local authorities, up to 1973, found themselves continually responding to changes in the external value of both the pound and the U.S. dollar, pegging and un-pegging now to one, now to the other in an effort to mitigate the economic effects flowing from changes in the values of these currencies. This situation stemmed from the fact that, while the country tended to keep the major part of its reserves in sterling, the bulk of its commercial relationship is with the United States which provides most of its foreign exchange and supplies most of its imports.

Another area in which there was some change relates to the currency composition of external reserves. While the 1965 Currency Act permitted the holding of certain U.S. dollar assets, the BMA legislation (no doubt out of deference to the Sterling Area Agreement mentioned earlier) restricted the external currency backing to gold (coin and bullion), sterling assets and other assets freely convertible into sterling (Section 21).

As far as the financial operations of the BMA were concerned, the relevant data are presented in Tables 6.3 and 6.4 which give a breakdown of liabilities and assets between 1969 and 1974. As can be seen, the largest single item on the liabilities side of the balance sheet were notes and coin issued by the Authority, which amounted to $33 million at the end of 1972, as compared to $28 million at the end of 1969, the figures for the other years fluctuating between $25 million and $32 million. The item accounting for the bulk of the increase in total liabilities between 1969 and 1974 was bankers' deposits which, after June 1971, represented mainly balances held with the Authority on the basis of an agreement between both parties to the effect that the banks (Clearing) would hold on deposit with the Authority 1 per cent of their total Bahamian dollar deposits, as part of an agreed 5.5 per cent minimum cash ratio.

TABLE 6.3

COMPOSITION OF BMA LIABILITIES, 1969 TO 1974
(END OF YEAR FIGURES)

B$m

Liabilities	1969	1970	1971	1972	1973	1974[a]
1. Notes & Coin in Circulation	27.8	25.9	25.1	33.2	32.0	27.7
2. Deposits: (a) Bankers'	0.5	–	1.9	4.2	3.6	8.6
(b) Others	–	0.3	0.3	0.5	1.6	0.7
3. Paid-up Capital	0.2	0.2	0.2	0.2	0.2	0.2
4. General Reserves	1.3	2.0	2.5	2.4	3.9	3.6
5. Surplus & Other Reserves	0.2	0.3	1.8	0.5	1.5	4.2
6. Other Liabilities	0.0	0.4	1.2	1.4	1.0	1.8
7. Total	**30.0**	**28.8**	**33.0**	**42.4**	**43.8**	**46.8**

a: End of June figures.

Sources: Central Bank of the Bahamas, *Quarterly Review*, various issues and BMA *Annual Reports*.

General Reserves was a special fund established by the BMA Act, to which the net profit or loss of the Authority was to be transferred at the end of the year, after deduction of operational expenses and provisions for bad and doubtful debts, depreciation in assets, contributions to staff superannuation funds and other contingencies were made. The actual amount transferred was dependent on the level of the Fund in relation to the demand liabilities of the Authority at the end of the year. If the proportion was less than 10 per cent the whole of the net profit earned in that year was credited. On the other hand, if the Fund was equal to, or exceeded 10 per cent but was less than 15 per cent of demand liabilities, one half of the net profit or such smaller amount as would have made the Fund equal to 15 per cent of demand liabilities was transferred. Where the proportion was equal to or exceeded 15 per cent, further credits could only be made with the agreement of the Minister of Finance. After the reserves provisions were satisifed, remaining profits were to be transferred to the Consolidated Fund from which operational losses incurred by the Authority were also to be met in the event that such losses exceeded the amount in the General Reserve Fund (G.R.F.). The net addition (+) or deduction (–) to or from the latter (Col. 2) at the end of each year between 1969 and 1973 as well as the year-end G.R.F./demand liabilities ratio (Col. 3) are shown below:

Year	Amount B$	G R F./Demand Liabilities %
1969	+ 1,150,467	4.6
1970	+ 763,301	7.9
1971	+ 478,113	9.2
1972	– 136,525	6.3
1973	+ 1,536,905	10.6

Given the position shown in Column (3) for the period, the Reserve Fund tended to be the recipient of all profits earned in accordance with the provision of the Act. The figures in Column (2), however, do not represent operating surplus for the Authority at the end of the respective years shown. According to the Caribbean Devlopment Bank Act, 1970, and the Bahamas Monetary (Amendment) Act, 1970, all sums to be paid by the Government for shares in the Caribbean Development Bank (CDB) were to come out of the General Reserve Fund, which was accordingly affected as such payments were made from time to time. In 1971, for example, though profits amounted to $773,563, the contribution to the G R F. for that year was only $478,113, the difference accounted for by subscription payments to the CDB. The same situation obtained in 1972 which saw a reduction in the Fund, as a result of the excess of the CDB payment ($278,146) over net profit ($141,621) in that year.

Looking at the assets side of the picture in Table 6.4, we observe that foreign reserves were the most dominant item accounting for $40 million out of total resources of $44 million at the end of 1973. As a proportion of currency notes in circulation, the foreign assets position of the Authority was for most of the time considerably above the minimum of 50 per cent laid down by the regulations (See Table 6.5), indicating that the flexibility permitted by the Act did not have much practical significance in terms of local securities holding by the monetary authority. This situation, however, would seem to owe its explanation more to domestic institutional and economic factors than to the policy of the BMA administrators, who under the regulations were permitted to certain amount of discretion in the choice of assets, once certain basic requirements were observed. With respect to B$ assets, the law specified both the minimum (defined as the difference between the face value of currency notes in circulation and the total holding

TABLE 6.4

COMPOSITION OF BMA ASSETS, 1969 TO 1974 (END OF YEAR FIGURES)

B$m.

	Assets	**1969**	**190**	**1971**	**1972**	**1973**	**1974[b]**
1.	External Reserves[a]	18.3	17.0	20.8	32.0	40.0	43.2
	(a) Bal. with Bankers	10.3	8.2	9.1	13.9	29.2	33.1
	(b) U.K. Treasury Bills	0.5	1.3	3.3	8.9	0.8	–
	(c) Other Foreign Securities	7.5	7.5	8.4	9.2	10.0	10.1
2.	Bah. Government Treasury Bill	1.5	1.5	2.7	0.9	0.5	–
3.	Bah. Government Promissory Notes	8.0	8.0	8.0	8.0	–	–
4.	Other Bah. Government Securities	–	–	–	–	–	–
5.	Currency Bal. with Bankers	2.0	1.5	0.1	0.0	0.7	0.3
6.	Other Assets	0.2	0.8	1.4	1.5	2.6	2.7
7.	**Total Assets**	**30.0**	**28.8**	**33.0**	**42.4**	**43.8**	**46.8**

a Includes foreign balances held locally; $2.4m (1969); $2.0m (1970) and $1.8m (1971).

b: End of June position.

Sources. Central Bank of the Bahamas, *Quarterly Reviews,* various issues and BMA *Annual Reports.*

of external reserves stipulated in Sect. 21), which was to be hold at all times and the form they should take. The latter was confined to the following: (a) Treasury bills issued by the Government and maturing in not more than ninety-three days; (b) securities issued or guaranteed by the Government. (Securities maturing more than five years from the date of acquisition, however, were not to constitute more than one half of local assets). While no maximum was explicity stipulated, theoretically the upper limit to holdings of B$ assets would have been total assets less 50 per cent of the value of the currency notes in circulation.

Looking at Table 6.4 the indications are that at no time was credit extended to the Government in the form of direct loans and advances by the Authority. Even the Treasury Bill figure that appears in the portfolio (after April, 1971) arose, not so much from the desire to provide the Government with funds, as from the attempt to imbue this instrument with a marketable character by offering continuous discount and sales facilities to the private sector. The Bill, while useful in assisting Government with the normal cash flow problem, was primarily aimed at providing institutional lenders with an outlet for employment of short term funds. The fact that offers have invariably been over-subscribed would suggest that there was no need, at any time, for the BMA to enter the market as a lender, which it did in the first two years of its existence, purely no doubt, out of the desire to acquire some local liquid assets, for its own portfolio. Even longer term stocks were not available until 1974, when Government, in an attempt to absorb available long term funds, made its first issue which, as indicated earlier, was over-subscribed. The relatively high foreign exchange position maintained by the Authority, therefore would seem to be at least partly explainable by the absence of sufficient local assets of the desirable quality in a situation which itself reflected the inability of the Government to formulate a proper long term programme of development which could incorporate the use of all available resources. Borrowing for borrowing sake merely to broaden the market, with no well-conceived aims or carefully articulated policies, can lead to an inefficient allocation of resources, and is, therefore, not a course that is easily recommended.

In more recent years, as we shall see later, Government's internal and external debt has increased significantly as part of an increasing involvement in development activities. Concomitant with the growth of this foreign indebtedness, there has been a parellel accumulation of foreign assets that has been far in excess of statutory requirements, the level of which itself may have no rational basis. To the extent that interest payments exceed interest receipts for any given volume of foreign funds, there is a net monetary cost to the country. This, of course, is in addition to the development 'cost' involved in keeping excess foreign reserves, we discussed earlier with reference to the Currency Board system.

A final point we might note in respect to Table 6.4 is that although the BMA was empowered to lend money to the commercial banks, this function never assumed any significance. The major reason for this, of course, is to be found in the nature of the banking system which has a number of recourses open to it in the event of a liquidity problem. The one chosen by an institution at any particular time may not only be influenced by the

TABLE 6.5

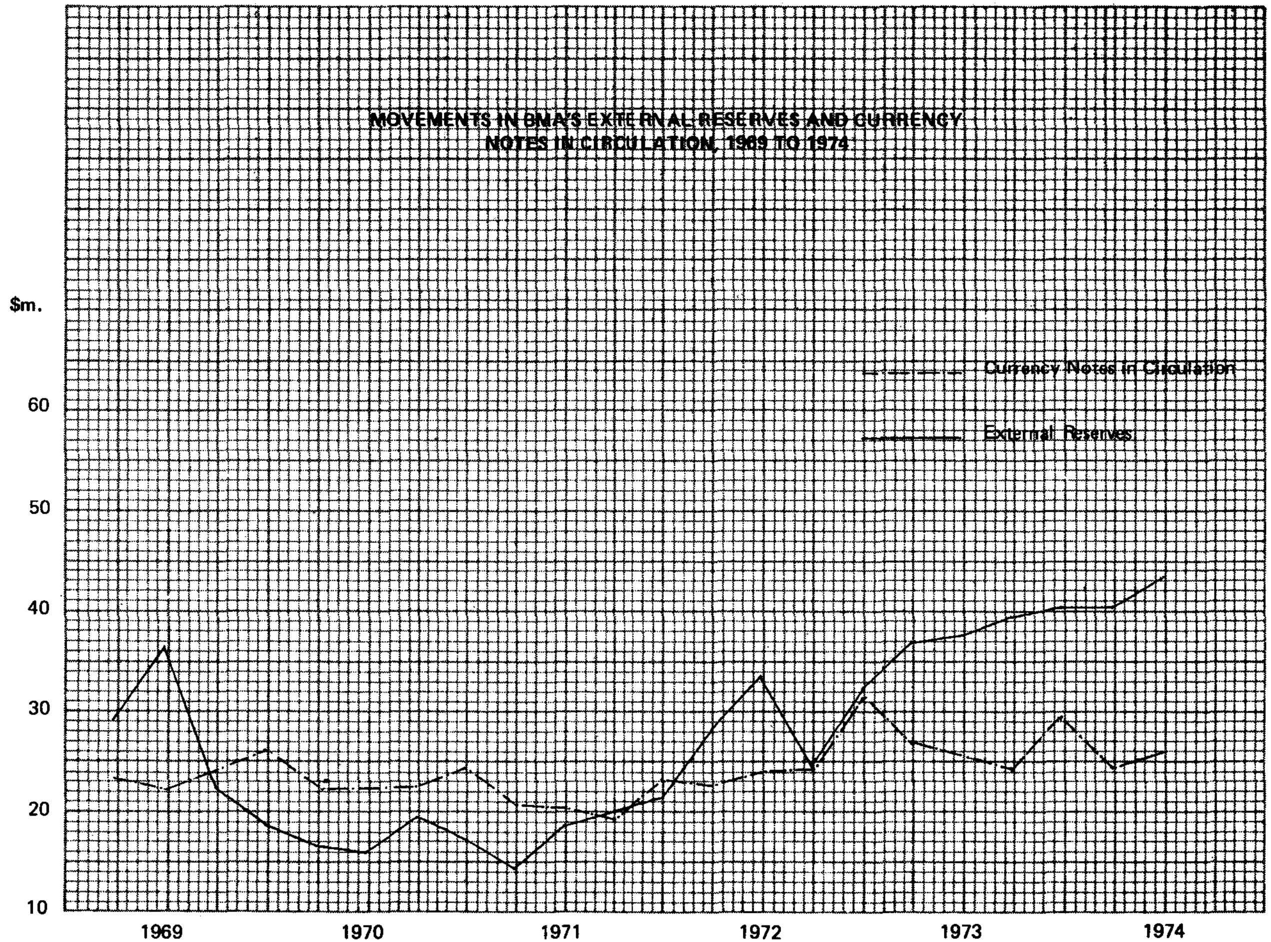
EXTERNAL RESERVES OF BAHAMAS MONETARY AUTHORITY AS A PROPORTION OF CURRENCY NOTES IN CIRCULATION, 1969 TO 1974

B$'000 End of Period	(1) Currency Notes in Circulation	(2) External Resserves[a]	(3) (2) as a % of (1)	(4) Required Reserves	(5) Excess Reserves
1969					
Jan.	23,941	30,758	128.5	11,970	18,788
March	23,212	29,082	125,3	11,606	17,476
June	22,414	36,063	160.9	11,207	24,856
Sept.	23,834	22,726	95.6	11,917	10,809
Dec.	25,912	18,313	70.7	12,956	5,357
1970					
March	22,440	16,391	73.0	11,220	5,171
June	22,278	15,994	71.8	11,139	4,855
Sept.	22,145	19,255	86.9	11,072	8,183
Dec.	23,944	16,996	71.0	11,972	5,024
1971					
March	20.700	14,044	67.8	10,350	3,694
June	20,358	18,180	89.3	10,179	8,001
Sept.	19,383	19,425	100.2	9,691	9,734
Dec.	23,121	20,851	90.2	11,560	9,291
1972					
March	22,477	27,950	124.3	11,238	16,712
June	23,186	33,771	145.6	11,593	22,178
Sept.	23,870	24,049	100.7	11,936	12,114
Dec.	30,872	31,952	103.5	15,436	16,516
1973					
March	26,281	36,827	140.1	13,140	23,687
June	25,450	37,039	145.5	12,725	24,314
Sept.	24,842	39,107	157.4	12,412	26,686
Dec.	29,392	39,953	135.9	14,696	25,257
1974					
March	24,461	40,015	163.6	12,230	27,785
June	25,109	43,238	172.2	12,554	30,684

a: Includes foreign balances held locally.

Source: Central Bank of the Bahamas, *Quarterly Review*, various issues.

FIGURE 6.1



MOVEMENTS IN BMA'S EXTERNAL RESERVES AND CURRENCY
NOTES IN CIRCULATION, 1969 TO 1974
$m.
60
50
40
30
20
10
1969
1970
1971
1972
1973
1974
Currency Notes in Circulation
External Reserves

cost and availability of funds, but possibly by the desire to insulate itself from official direction or pressure as much as possible. For this reason, borrowing from official sources may be resorted to only in certain extreme situations.

THE CENTRAL BANK OF THE BAHAMAS

From our earlier discussion on the transition from the modified Currency Board system to the Bahamas Monetary Authority arrangements, it seems clear that the present Government started toying with the idea of a Central Bank as far back as 1968, though no explicit undertaking was given that the BMA would gradually be transformed into an institution of this kind. Subsequent pronouncements, however, starting in 1970[32] left no doubt in the public's mind that it was the firm intention of the Government to introduce an establishment with modern central banking powers as soon as it thought it appropriate to do so. Though the country had attained 'sovereignty' in currency matters following the constitutional changes in 1964, and had moved to streamline the colonial arrangements with the setting up of the BMA in 1968, it was obvious that once full political independence was attained, an institution to smybolise the new status and at the same time enhance the financial image of the country would receive urgent consideration. In fact, in the Independence White Paper presented to Parliament in October of 1972, it was specifically stated that it was the Government's intention that a Central Bank should evolve from the then Bahamas Monetary Authority which was conceived with some haste in an atmosphere of crisis following the 1967 sterling devaluation.

Though in the White Paper cited above, it was indicated that the new institution would come into existence before the date of Independence, it was not until almost one year later (June, 1974) that the relevant legislation was presented to Parliament in the form of the Central Bank of the Bahamas Act, 1974, which repealed the Bahamas Authority Act of 1968 and laid the legal foundation for the new institution. All the provisions of the law, however, did not take immediate effect, time naturally being required to phase in the new arrangements, particularly those between the CBB and the other institutions affected by the legislation. At the time of writing, the Bank had been in operation for a little over five years, and while in this period certain functional characteristics associated with a Central Bank had emerged, the limited experience does not permit an adequate assessment of the institution's impact or its perceptions of its role in the conditions prevailing in the Bahamas.

In the following paragraphs, while we shall make reference to certain salient trends which have emerged, the discussion in the first section will focus largely on the main provisions of the Central Bank's statute, particularly those that help define the nature and powers of the Bank. In the second section, we examine some of the traditional techniques of monetary control and the scope of central banking operations in the Bahamas, given the economic and financial structure of the country, which we have discussed in previous chapters.

I. The Legal Framework

Thomas has made the useful observation that "banking laws and institutional structures, no matter how carefully thought out and ideally constructed, cannot by themselves guarantee efficient management and effective policy formation".[33] Our purpose here is not appraise the efficiency or policies of the Central Bank of the Bahamas for reasons indicated above, but to provide an insight into the legal structure of the institution and its functional orientation.

Like the BMA, the Central Bank has been established as a body corporate having perpetual succession and a common seal, and which may sue and be sued in tis corporate name. Set up with an authorised capital of three million dollars,[34] the institution is fully owned by the Government for whom it is intended to perform certain specified functions such as to issue notes and coins in the Bahamas (over which the Bank has sole right and authority), to act in the capacity of banker to the government or any public corporation, to manage the public debt, and though not explicitly stated, to implement Government's monetary policies and generally to act as agent for the Government "on such terms and conditions as may be agreed between the government and the Bank where the Bank can so act consistently with its functions under this Act."[35] The latter includes the management of the country's external reserves, since this is closely related to the Central Bank's other monetary functions. In its capacity as banker to the government, the Bank is not only authorised to open accounts for or accept deposits from Government, but is also permitted to make temporary advances to the latter from time to time on terms as may be agreed between the Minister of Finance and the Bank. The amount of any such loans, however, which may be outstanding at any time should not exceed 10 per cent of the "average ordinary revenue"[36] of the Government or 10 per cent of its "estimated ordinary revenue", which ever is less. The Act, it should be noted, does not specify any time limit within which loans to Government should be repaid, as the statutes of some countries have done. It simply states that such loans should be repaid "as soon as possible",[37] leaving considerable room for discretion. A glance at Table 6.6 shows that at the end of 1978, outstanding advances, to Government stood at $12.5 million. This amounted to 8 per cent of ordinary revenue as defined by the Act.[38]

While the Governor is the chief executive of the Bank and is responsible for its day-to-day running and operation, the policy of the Bank as well as its overall management had been entrusted to a Board of Directors consisting of the Governor and the Deputy-Governor (both of whom are not to be appointed or re-appointed for periods exceeding five years[39] at a time) and four other directors, who, in the opinion of the Governor General, satisfy the criteria of having "wide experience in, and to have shown capacity in,

TABLE 6.6

ASSETS OF THE CENTRAL BANK, 1974 TO 1978
(End of Period)

$m.

	Assets	1974	1975	1976	1977	1978
1.	External Assets	41.5	45.5	45.9	67.2	58.8
	(Balances with Crown Agents and Bankers)	(36.6)	(43.8)	(35.2)	(54.9)	(45.8)
	(Marketable Securities Issued or Guaranteed by Foreign Govts)	(1.9)	(1.7)	(4.9)	(5.8)	(6.0)
	(Gold Bullion)	(–)	(–)	(–)	(0.4)	(0.5)
	(Bahamas Gold Tranche with IMF)[a]	(–)	(–)	(5.8)	(6.1)	(6.5)
2.	Fixed Assets	3.0	3.5	3.3	3.2	3.1
3.	Advances to Government	–	9.8	10.8	13.1	12.5
4.	Bahamas Registered Stock (at cost)	0.3	0.0	4.0	–	1.4
5.	Bahamas Govt. Treasury Bills at Cost plus Accrued Discount	9.5	–	3.9	–	1.0
6.	Loans to Commercial Banks (secured)	1.6	–	–	–	–
7.	Other	0.5	0.7	0.6	1.2	5.8
	Total	**56.4**	**59.5**	**68.7**	**84.7**	**82.6**

a. Prior to March 31, 1976, this account was held by the Treasury.

Source: Central Bank of the Bahamas, Annual Reports.

financial or commercial matters, industry, law or administration"[40] The Financial Secretary is a member ex officio. Not eligible for appointment to the Board are members of Parliament (both Houses), public officers and directors, officers, servants and shareholders of any financial institítions carrying on banking business, as well as persons having a controlling interest in any such institutions. The Governor and Deputy-Governor, while in office, can accept other employment or positions (with or without re-numeration) only with the prior approval of the Governor General. The latter is also empowered to appoint eligible persons as temporary directors in the event of absence or inability to act, of a director in office.

The Board has to meet at least once a month, but can meet at more frequent intervals if the necessity arises. Three directors (one of whom has to be the Governor or Deputy-Governor) constitute a quorum. Decisions are adopted by a simple majority of the directors present, and in the case of an equality of votes the person presiding has a casting vote. Under Section 10–(6) a director can be excluded from deliberations or decisions concerned with a contract or transaction involving the Bank, and in which the particular individual has an interest other than in the capacity as a director of the Bank.

As indicated earlier, the authorised capital of the Bank has been set at three million dollars, of whch all has been paid up (See Table 6.7). The

TABLE 6.7

LIABILITIES OF THE CENTRAL BANK, 1974 TO 1978
(End of Period)

Liabilities	**1974**	**1975**	**1976**	**1977**	**1978**
1. Notes and Coin Circulation	28.6	29.8	30.9	33.7	38.2
2. Deposits by Commercial Banks	13.1	14.9	13.4	12.8	16.5
3. Deposits by Govt. & Govt. Agencies	1.3	1.3	7.9	20.3	3.9
4. Caribbean Development Bank Promissory Notes	0.8	1.0	1.5	0.5	–
5. Accounts of IMF and World Bank	0.3	0.3	0.4	0.6	4.8
6. Capital (Issued and Fully Paid-up)	0.2	3.0	3.0	3.0	3.0
7. Exchange Equalisation Account	1.0	1.2	0.9	0.9	2.7
8. Reserve for Contingencies	0.5	0.4	0.7	0.4	0.7
9. General Reserves	6.6	7.1	8.1	10.2	9.5
10. Other Liabilities	4.0	0.5	1.9	2.3	3.3
Total	**56.4**	**59.5**	**68.7**	**84.7**	**82.6**

Source: Central Bank of the Bahamas, *Annual Reports.*

regulations require a General Reserve Fund to be set up to which the net profit [41] or net loss of the Bank is to be credited or debited as the case may be at the end of the each year. If at the end of the year the position is such that the amount in the General Reserve exceeds twice the authorised capital of the Bank or 15 per cent of its demand liabilities (whichever is greater), the excess has to be paid over to the Consolidated Fund, unless the Minister of Finance otherwise determines. While a maximum General Reserve level is explicitly recognised in order, no doubt, to divert some part of the earnings to other general purposes, the Act does not establish a minimum level or specify the funding source in the event that the reserves were to dip below this level, or were to be wiped out by losses incurred in operations. Since, however, the Consolidated Fund is credited with the excess earnings of the Bank, one would assume that losses will also be met from this source, even though this is not explicitly stated.

The accounts of the Bank are to be audited annually by auditors appointed by the Board of Directors with the approval of the Minister of Finance, to whom a report of the operation of the Bank plus a statement of the accounts, certified by the auditors, are to be submitted within four months after the end of each financial year.[42] In addition, the Bank is required on or before the end of every month, to transmit to the Minister and to publish in the Gazette a statement of its assets and liabilities at the last working day of the preceding month.

In preparing its accounts, the Bank is required to exclude from its calculations any profit or loss arising from any revaluation of its assets or liabilities occasioned by a change in the value of the Bahamian dollar or any other foreign currency. Profits or losses arising in this fashion are to be credited or debited to the Exchange Equalisation Account specially set up for this purpose.

Currency Arrangements

The currency of the Bahamas is the dollar which is divided into one hundred cents. As mentioned earlier, the Bank has not only the sole right of issue, but the obligation to re-issue and redeem its own notes and coins. The parity of the dollar, it should be noted, is not fixed in terms of a foreign standard with which it would have moved automatically with any change in the latter, but in terms of gold, and can be altered by the Minister of Finance ("after consultation with the Bank") without going to Parliament as was the case in the pre-BMA days.

The minimum foreign assets the Bank is permitted to hold is set at "fifty per centum of the value of the aggregate of the notes and coins in circulation and the demand liabilities of the Bank". Stated in this form, it makes it difficult for the bank to create foreign demand liabilities to meet the legal minimum as would be the case where external assets are related only to currency in circulation. In some countries, minimum foreign reserves requirements are related to the value of imports for a specified time period, as in Kenya and Tanzania, this being the value of imports during four months as averaged for the three preceding years. Whatever the variable to which reserves are related, the effect of prescribing minimum ratios is to immobilise or freeze a substantial part of the country's gold and foreign exchange,[43] and it is therefore instructive to analyse the reasoning behind this outmoded practice. This practice was slavishly adopted from older institutions (many of which, incidentally, have now done away with a statutory minimum or greatly reduced the original figure) by many of the new central banks in Africa and the Caribbean, no doubt, under the conviction that this would add to the local and international prestige of the currency which was, and still is considered to be an important factor in attracting foreign investment.

In the days of the Gold Standard system, the major purpose of monetary reserves was to ensure the ability of the Central Bank to redeem its notes and liabilities in specie. Since then, with the changes that have taken place, both in the domestic and international financial systems, the function of gold and foreign exchange (which now comprise central banks' reserves) has come to be related more to external transactions, the actual holdings being influenced by such factors as variability in international receipts and payments, and the level of imports.[44] For purposes of maintaining confidence in the currency, however, both at home and abroad, and of putting a limit on the Central Bank's power to expand credit, most of the legislations in the post-war period have continued to stipulate minimum reserve holdings, either related to the currency issue or, as is more often the case, to currency and demand liabilities.[45]

Such a practice not only does not provide a guarantee against inflation or a fall in confidence in the national currency, but as pointed out earlier, has the effect of freezing a substantial part of the country's foreign reserves, leaving only the 'free' portion available for dealing with balance of payments deficits and maintaining the external value of the currency. Recognition of this fact has led many countries to insert provisions in their respective legislations for suspension of the minimum reserve backing in times of a payments crisis.[46] Some states have gone further and eliminated altogether the statutory cover requirement for the note issue, and in its place have substituted more flexible procedures consistent with the largely international function of foreign reserves. In place of a ratio, the Central Bank of Ceylon, for example, has been given guidelines based on foreign currency obligations and availabilities in determining adequacy of reserves at any point in time.[47] Nearer home, the Central Bank of Barbados is simply asked to 'use its best endeavours to maintain the Reserve of External Assets, at a level adequate for the International transactions'[48] of the country. In Latin America several countries try to control their external position by restricting the rate of increase in money supply over specified periods and by placing limits on the sale of foreign exchange. The intention implicit in these arrangements is clearly to escape the virtual non-functional minimum stipulation (which has its basis in an era long since past), while at the same time taking care that the external assets of the countries do not fall below acceptable levels determined by foreign commitments and requirements.

A glance at Table 6.8 shows that the level of foreign reserves held by the Central Bank in relation to its demand liabilities has generally been far in excess of the required minimum. At the end of 1978, for example, the ratio was 93 per cent. The tendency to hold foreign reserves far above the required minimum may reflect the view that conditions in the Bahamas warrant a higher ratio than the statutory figure. It may also, of course, be the result of a passive policy conditioned by a high degree of cautiousness and uncertainity and the absence of a carefully articulated long term financing strategy by Government. With respect to the assets which the Bank can hold in its foreign reserves portfolio, the legislation permits a broad range of options both in terms of currency and instruments. The major advantage of this approach is that it permits a greater flexibility in the pursuit of objectives relating to financial security and profitability. Under Section 18—(1) of the Act foreign assets can be held in the following forms:

(a) gold (whether coins or bullion);

(b) notes and coins (other than gold coins);

(c) balances payable on demand held with financial institutions or agents;

(d) money at call;

(e) bills in the nature of Treasury Bills maturing within one hundred and eighty-four days issued by any foreign government;

(f) marketable securities issued or guaranteed by any foreign governments (securities with a maturity of more than five years are not permitted to form more than 30 per cent of total external reserves);

(g) any reserve asset deemed by the Board of Directors to be an internationally recognised reserve asset.

As pointed out earlier, in recent years foreign assets are now heavily concentrated in U.S. dollar denominated balances and instruments. At the end of 1978 such assets formed more than 80 per cent of the Central Bank's foreign reserves. The bulk of the external funds are held in the form of balances with the Crown Agents or Bankers (See Table 6.6). Marketable securities issued or guaranteed by foreign governments increased from \$1.9 million (4.6 per cent of external assets) at the end of 1974 to \$6.0 million (10.2 per cent of external assets) at the end of 1978.

In the context of the present international monetary system which permits countries to pursue arrangements involving daily movements in exchange rates, the questions of foreign debt management and exchange rate policies have become a great deal more complicated than was the case under the rigid Bretton Woods system prevailing until the early 1970s. The

TABLE 6.8

CENTRAL BANK: EXTERNAL RESERVES AS A PROPORTION OF TOTAL DEMAND LIABILITIES, 1964 TO 1978

$m End of Period	(1) Total Demand Liabilities	(2) Required External Reserves	(3) Actual External Reserves	(4) Excess Reserves	(5) (3) as a % of (1)
1974					
March	41.2	20.6	40.0	19.4	97.1
June	38.7	19.4	43.2	23.8	111.6
Sept.	39.2	19.6	43.2	23.6	110.6
Dec.	44.2	22.1	41.5	19.4	93.6
1975					
March	46.3	23.2	51.9	28.7	112.1
June	57.3	28.7	60.3	31.6	105.2
Sept.	46.6	23.3	49.9	26.6	107.1
Dec.	47.2	23.6	45.5	21.9	96.4
1976					
March	64.7	32.4	63.8	31.4	98.6
June	65.0	32.5	66.6	34.1	102.5
Sept.	46.0	23.0	48.9	25.9	106.3
Dec.	54.2	27.1	45.9	18.8	84.7
1977					
March	60.7	30.4	59.7	29.3	98.3
June	71.1	35.6	68.9	32.3	96.9
Sept.	68.2	34.1	66.5	32.4	97.5
Dec.	68.0	34.0	67.2	33.2	98.8
1978					
March	76.0	38.0	76.4	38.4	100.5
June	87.5	43.8	93.6	49.8	106.9
Sept.	65.5	32.8	89.4	56.6	136.5
Dec.	63.5	31.8	58.8	27.0	92.6

Sources. Central Bank of the Bahamas, *Quarterly Review* various issues; *Annual Reports* of the Central Bank.

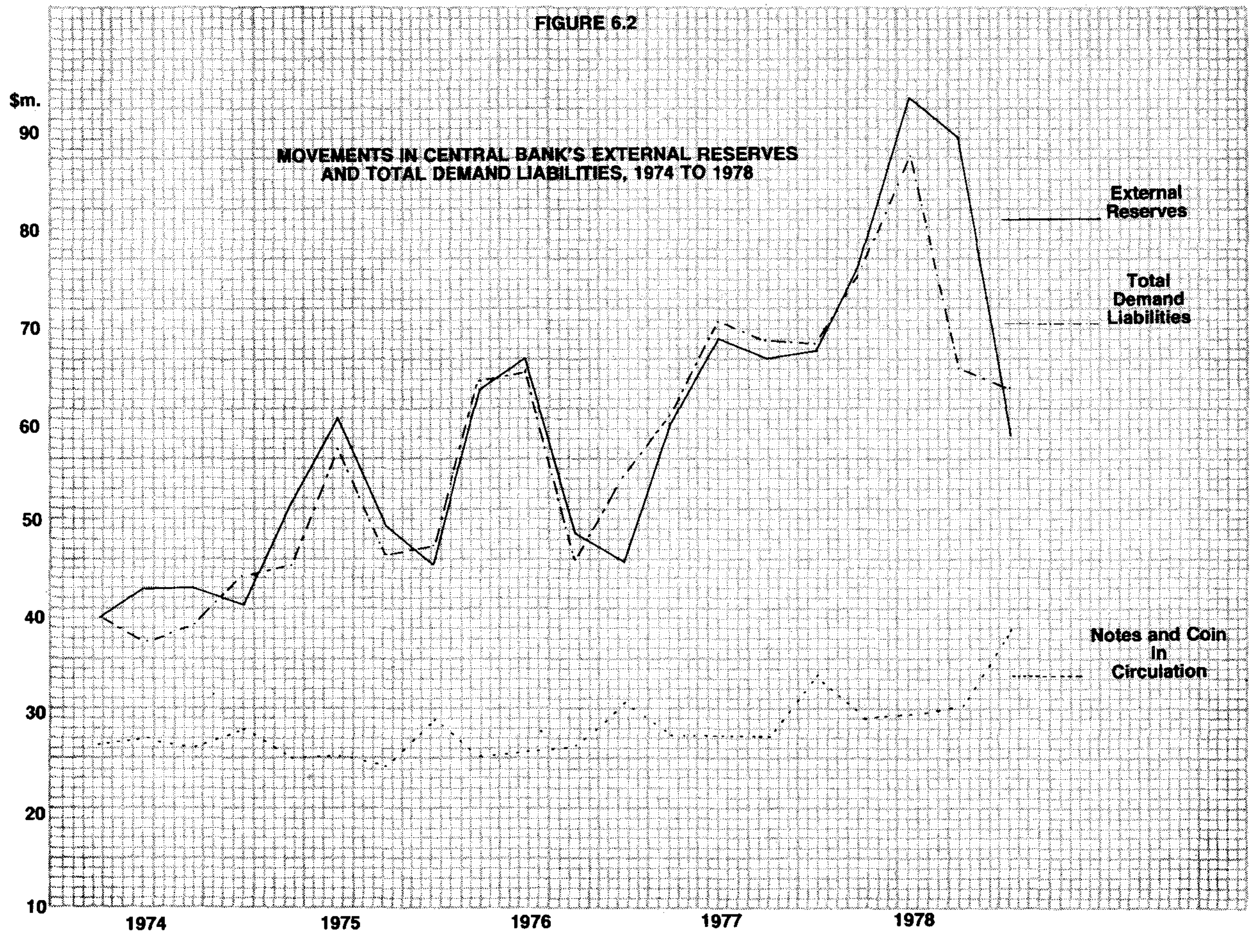


FIGURE 6.2

MOVEMENTS IN CENTRAL BANK'S EXTERNAL RESERVES AND TOTAL DEMAND LIABILITIES, 1974 TO 1978 floating of the major currencies means that the external value of these currencies vis-a-vis one another experience daily fluctuations. While this increased flexibility may have succeeded in eliminating some of the adjustment difficulties that arose under the previous arrangements, developing countries generally have expressed a preference for a more stable system of exchange rates. For these countries movements in the external values of the major currencies not only have implications for the value of their reserves, but also for their exchange rates and ultimately for their development prospects.

While an increasing minority peg their currencies to the Special Drawing Rights (SDR) or some other currency basket, the majority still peg to one of the major curriences. At mid-1979, more than forty countries (including the Bahamas) had their currencies pegged to the U.S. dollar. Pegging, of course, under a system where the major currencies are floating, is quite different from a situation where these curriences have a fixed relationship to one another. Under the former the externally induced changes in exchange rates on a continuous basis require an explicit coordination of policies with respect to trade, debt and reserve management and exchange rate policies if the adverse effects on the domestic economy are to be mitigated. A passive or indifferent approach in these circumstances could easily lead to losses and disruptions which can have a dampening effect on the growth of the economy, even when the nominal values of certain indices appear to be unaffected. Developing countries do not have the same scope for monetary or exchange rate policies as the developed countries, and certain options (e.g. floating) are generally not feasible. The changes which have taken place in recent years in the international monetary environment, however, call for the urgent development of expertise and management techniques consistent with the higher degree of instability which now characterise the international monetary system.

A salient feature of central banking legislations in the post-war period has been the definition of a set of objectives which the establishment of the institutions is intended to achieve. Sometimes these can be quite broad and dynamic as in the case of Ceylon,[49] or very modest as is typified in the Bahamas Law. Section 5—(1) of the latter lists the duties of the Bank as follows:

(a) to promote and maintain monetary stability and balance of payments conditions conducive to the orderly development of the economy;

(b) in collaboration with the financial institutions, to promote and maintain adequate banking services and high standards of conduct and management therein;

(c) to advise the Minister on any matter of a financial or monetary nature referred by him to the Bank for its advice.

While summaries of this sort are generally not intended to provide an exhaustive explanation of the operational dimensions or functions of a bank, it does help to focus on what are considered to be critical variables in terms of principal and subsidiary objectives within the context of broader social and economic policies. From official statements, a very high priority tends to be placed on 'monetary stability' which is seen as a necessary prerequisite for the 'orderly' development of the economy. This perspective, of course, is in keeping with government's expressed intention of preserving the domestic and international value of the Bahamian dollar in order to maintain investors' confidence in the country, considered to be an essential element within the broader framework of the particular development strategy that is being pursued. As indicated several times earlier, outside capital and foreign entrepreneurs have not only played an important part in the recent economic growth of the country, but are envisaged (if one can judge by official reports and pronouncements) to play a crucial role in any future development.

While monetary stability is a desirable objective in the process of economic development, there is always the danger of this goal becoming the end rather than the means. In other words, development could be stifled in the interest of stability, if policy makers are not able to gauge the financial needs of the economy or to properly assess the scope for monetary policy in a dynamic situation. In this connection, there are three schools[50] of thought which should be briefly mentioned. One holds that once stability is maintained, growth naturally follows, money playing largely a passive role, the supply adapting automatically to the growth process.[51] The second view often described as permissive, states that an increase in the supply of money is a necessary, though not a sufficient, condition for economic growth. The third and final proposition which closely resembles the Keynesian postulate (formulated in the context of existing productive capacity) argues that an increase in the money supply by itself is sufficiently powerful to induce economic expansion, and vice versa.

Though our knowledge of the role of money in the development process is far from perfect, of the three positions cited, the second which envisages an active policy within limits would seem to be the most tenable within the framework of a developing society, where adoption of the first view with its potential for creating a deflationary situation, can have serious consequences for growth. On the other hand, given the economic structure of such societies, any attempt to increase output purely through monetary expansion will generally lead to increased imports, or in the absence of foreign exchange reserves, to increased prices, thus affecting the value of the currency with all that this implies for savings and investment. The permissive approach to monetary policy, which to an extent seeks to strike a balance, at least in effect, between these two extremes, is not free from problems of its own, since determining the optimum quantity of money necessary to facilitate real growth without inflation is no easy question for policy makers desirous of such an objective.[52]

Faced with a choice between a conservative and an active policy, and pressed by circumstances to play a pivotal role in the development effort, many governments in poor countries have opted for a dynamic approach, and in this connection have not hesitated to use their central bank facilities in financing part of their activities, with some effects on both output and prices. While, as we have pointed out before, an excessively high rate of inflation is bound to have repercussions on the savings-investment processes, a moderate level is often accepted as the cost of an active development policy, prices arising from which is seen as a means of transferring resources from the private to the public sector (forced savings) particularly in the absence of an inadequate fiscal system, or an inability to borrow.[53]

It has to be recognised, of course, that extreme openness does pose serious constraints on the use of monetary policy, even though the above arguments are not without relevance when considered in a long term perspective. In a situation where imports form a large part of total supply, increases in the money stock are immediately reflected in the level of foreign reserves. In the short term, the production base may be neither broad enough nor flexible enough to respond to any additional demand. Even if there is unemployed labour, the absence of complementary factors discourages any expansion in the availability of goods and services. An increase in the quantity of money in this latter situation, accompanied by measures designed to protect the balance of payments, will have the effect of increasing prices for available goods. Of course, in a situation where foreign reserves are available and access to goods produced abroad is not forbidden, excess demand resulting from an expansion in the money supply will be satisfied in the form of increased imports. It has been contended, not without justification, that "price increases in the Bahamas fall somewhere between increases in the United States and the United Kingdom", its major trading partners.[54] This close correlation between domestic and foreign prices has come about not because the money supply (however defined) has not increased (it generally has, see Table 6.9), but because reserves have been available to satisfy incremental demand. Even if the money supply decreases one will still find a close relationship between local and foreign prices for the simple reason that the bulk of requirements are normally met from abroad.

RELATIONS WITH THE COMMERCIAL BANKS

Under the law, the Bank is authorised to act as banker to any commercial bank in the Bahamas and as agent or correspondent to any bank abroad. Provision is also made for its involvement in the promotion of a clearing system and associated facilities.

A major purpose behind the establishment of a central bank has been the need not only to promote a strong banking structure, but to control domestic credit in which, as is well known, commercial banks tend to play a critical part. Accordingly, the Act empowers the Bank to operate a wide

TABLE 6.9

MOVEMENTS IN MONEY AND PRICES IN THE BAHAMAS, 1970–1978

End of Period	% Increase in Narrow Money	% Increase in Broad Money		% Change in Consumer Prices Bahamas	U.S.	U.K.
1970	– 8.9	– 9.0	1970=	100	100	100
1971	– 16.1	– 1.1		4.6	4.3	9.4
1972	+ 23.4	+ 7.4		7.1	3.2	7.1
1973	– 11.7	– 11.2		5.3	6.2	9.1
1974	+ 6.7	+ 11.4		13.1	11.0	16.0
1975	– 3.6	+ 9.3	1975=	100	100	100
1976	+ 3.7	+ 13.2		4.3	5.8	16.5
1977	+ 15.2	+ 10.2		3.2	6.5	15.9
1978	+ 18.7	+ 13.4		6.0	7.5	8.3
Annual Averages						
1969–73				7.1	4.9	8.0
1974–78				6.9	8.0	16.2

Sources: Table 2.29; IMF, *Financial Statistics,* various issues.

range of explicit instruments with a view to attaining these objectives.

The Statutory Reserve

Under Section 19 of the Statute, commercial banks are required to maintain a reserve amounting to a certain minimum percentage of deposit liabilities denominated in Bahamian dollars, a portion of which may be required to be lodged with the Bank. The Act lays down no fixed figure, but instead stipulates a range of between 5 per cent and 20 per cent within which the authorities can operate. In order to prevent too frequent and too large a change in the ratio within relatively short periods, thus causing undue hardships to the banks, a qualifying clause is inserted which prohibits any increase in a prevailing percentage by more than 5 per cent in any period of thirty days.

On the basis of a 5 per cent reserve requirement (1 per cent in till and 4 per cent with the Central Bank) commercial banks' deposits with the Central Bank amounted to $16.5 million at the end of 1978 (See Table 6.7). This represented 20 per cent of the Bank's total liabilities.

There are two points worth noting with respect to this regulation. Firstly, it does not distinguish between various types of deposits, as some legislations have tended to do, which would have allowed the authorities to apply different reserve ratios (ranging between zero and a maximum percentage) to the various categories of liabilities, thus increasing the flexibility in control. This point is particularly worth noting in the context of the observation that is often made that reserve requirements applied against non-demand deposits tend to put commercial banks at a competitive disadvantage vis-a-vis non-bank financial institutions.[55] Secondly, in view of the wide range of commercial banks operating in the Bahamas and the variation in interest, the law quite wisely permits the application of different percentages to different classes of banks, though, it should be pointed out, it does not say what criteria should be used in working out classifications for purposes of this regulation, or the following one which allows the same discretion.

As we shall see later, there are certain shortcomings attached to the use of liquidity ratios, one of them being the tendency to affect all banks, large and small, with the same severity, the differential impact resulting from various degrees of liquidity existing at the time the ratio is changed. In this connection, the use of variable requirements only in relation to increases in deposits and not to total deposits, has often been suggested to alleviate the bluntness of this instrument, and it is, therefore, to be hoped that the power to make this kind of adjustment is implied in the regulation.

The Liquid Assets Ratio

Section 20(i) of the Central Bank Act states that every "commercial bank shall so conduct its business as to ensure, taking one month with another, that its liquid assets are on average not less than that percentage of the amount of its deposit liabilities in Bahamian dollars that is at any time fixed by the Bank under this section". The percentage referred to can be varied between a minimum of 10 per cent and a maximum of 30 per cent, with the qualification that increases above any prevailing ratio shall not exceed 5 per cent in any period of thirty days. The legislation, it should be noted, however, does not provide a time specification for the notification of the effective date of any increase in the ratio.

Liquid assets are specified to include the following:

(a) notes and coins;

(b) any cash held at the Bank;

(c) money at call and demand balances at any financial institution carrying on business in the Bahamas;

(d) Treasury Bills;

(e) stock of the Government;

(f) bills of exchange, promissory notes, and other credit instruments;

(g) any freely convertible foreign currency;[56]

(h) money at call and demand balances at any financial institution abroad being money at call or demand balances held in freely convertible foreign currency;[57]

(i) any other asset designated by the Bank.

Lender of Last Resort

As banker to the commercial banks, the Central Bank is not only permitted to open accounts, or collect money for or accept deposits from them, but is also authorised to grant loans and advances on the basis of a wide range of security specified in the Act. The list includes the following:

1) gold coins or gold bullion;

2) bills of exchange, promissory notes, Treasury Bills, short term instruments with approximately six-month maturity and Government long term securities;

3) warehouse warrants or other documents to goods duly insured and secured by a letter of hypothecation from the owner;

4) fixed term and fixed interest securities of any company.

There are two stipulations governing the extension of Central Bank credit to the commercial banking sector. The first states that in cases where a loan or advance is made on the security of the instruments in 2) above, the accommodation period should not extend beyond the maturity date of the instrument itself, or ninety-three days, whichever is longer. The second qualification seeks to place a limit on the amount of credit extended, stating that the latter should not exceed 85 per cent of the market value of the security instrument at the date of its acquisition by the Bank.

Credit Controls

Another control weapon which has been entrusted to the Central Bank is the power not only to prescribe maximum limits on the volume of bank credit, but to specify the purposes and maturities for which they are required, as well as the security on which loans or advances may or may not be made by commercial banks.

Control Over Interest Rates

In view of the narrow scope for the employment of many of the conventional monetary instruments, it seems rather odd that the Bank has not been empowered either to fix minimum and maximum interest rates on deposits or to place limits on lending rates for financial institutions generally. As pointed out in an earlier chapter, the terms of bank lending remain largely unregulated.

General Powers

Besides being able to act in a depository capacity for the commercial banks and Government, the Central Bank can, in addition to Treasury Bills, buy, hold, sell, discount or rediscount bills of exchange, promissory notes and other credit instruments maturing within 180 days from the date of acquisition by the Bank. It is also permitted to buy, hold and sell long term securities issued or guaranteed by the Government and having maturity of twenty years, providing that the total of such securities maturing beyond five years after their date of issue (including securities held as security for loans or advances) does not exceed 20 per cent of the demand liabilities of the Bank. For purposes of promoting a capital market, the Bank is also authorised to deal in fixed term and fixed interest securities of any company (including a public corporation or a company established for the purpose of developing a securities market, or financing economic development in the Bahamas), to the extent that the total value held at any time does not amount to more than 5 per cent of its (the bank's) total liabilities.

In order to broaden the range of securities available, and at the same time increase its own operational flexibility, the Bank might have been empowered to issue its own obligations, perhaps guaranteed by the Government.

In order to carry out its finction, the Central Bank naturally requires a wide range of data which it is authorised to demand from trust companies and financial institutions, provided that this does not involve the disclosure of information relating to the deposits of individual customers. A 'financial institution' is defined by the law as one engaged in 'Banking Business' which means "the business of accepting deposits of money which may be withdrawn or repaid on demand or after a fixed period or after notice, and employing deposits in whole or in part by lending or otherwise investing them for the account and at the risk of the person accepting them". From this definition it would appear that the Bank cannot, on authority, request information from an institution engaged wholly in borrowing money, either domestically or from abroad, and re-lending these resources either directly or through some sort of hire-purchase business. Even though the number of operations falling in this category is very small at the moment, provision should have been made for their coverage, given their connection with the overall credit system and the need to monitor all components of the money market. This brings us to another related point which emerges very glaringly from an examination of the Central Bank legislation, and this is the total preoccupation, as far as control techniques are concerned, with the commercial banking system. Non-bank intermediaries on which a great deal has been written in recent times in the context of their effects on monetary policy, have not been recognised as needing any defined relationship with the Bank or Government beyond the voluntary financial links that take effect in the normal course of business.[58]

Prohibited Activities

The Bank is not permitted to engage in trade, hold a direct interest in any business undertaking (except such as it has acquired in the satisfaction of debts due to the Bank, but these are not to be held permanently) or grant unsecured loans or advances to any person. It is further stipulated that the Bank shall not acquire any interest in real property, except as may be necessary for the conduct of its business or for incidental purposes.

PERCEPTIONS OF CENTRAL BANKING IN DEVELOPING COUNTRIES WITH SPECIAL REFERENCE TO THE BAHAMAS

From the foregoing, it is clear that there is little that is innovatory in the legislation. In fact it is very much in the mould of those that have emerged in Commonwealth countries in the post-war period, simplicity being one of their prominent virtues. Excluding the second schedule which contains consequential amendments, the Bahamas Act contains 56 articles as compared to over 100 for many Latin American countries.[59]

The establishment of central banks in newly independent countries has not surprisingly evoked a great deal of discussion on their effectiveness and possible role in the context of the conditions prevailing in these countries. One school of thought holds that they are nothing but a 'costly luxury'[60] intended to enhance the prestige of the government and the country, their establishment having little effect beyond symbolic significance. Some observers see them as little more than a convenient instrument for financing inflationary budget deficits. Another and increasingly more prevalent view contends that their role in a developing nation should not be viewed strictly in terms of the objectives with which their counterparts in the more developed states are associated, namely, maintaining a high level of employment without too much inflation or deflation. Instead, their establishment in poor nations has to be seen as part of the general development effort, the priority objectives being the strengthening of the financial infrastructure, encouragement of the growth of money and captial markets and assisting in the general expansion of the economic system via selective credit controls and so forth.

This view of course does not deny that central banks in developing economies can adequately perform such traditional central banking role as issuing and redeeming currency, acting as banker and fiscal agent to the government, managing the country's gold and foreign exchange reserves and in some circumstances even successfully carrying out one of the more modern functions, that of regulating credit by using a combination of old and new techniques. The emphasis it is agreed, however, has to be on its role in the development effort aimed at modernising the economy and eliminating proverty and unemployment. Towards these ends attention has, of necessity, to focus on capital formation, encouragement of savings and the efficient utilisation of the country's limited resources, instead of on stabilisation policies using the mechanisms of the money market, which may be non-existent or virtually so. With the development of the latter, the use of traditional techniques in controlling the credit of commercial banks may become much more feasible. It is therefore senseless to try to judge the relevance of a central bank purely in terms of what it could accomplish in the existing financial and institutional framework.

In practice, it is largely this long term perspective which has prevailed, even though the central banks are normally equipped with the whole gamut of control instruments at their very inception, the view no doubt, being that effectiveness will grow with time, and it is better to incorporate them at an early stage in the statute, rather than face the problem of amendments at a later date. In other words, a central bank is not only perceived as an agency for centralising a whole range of functions hitherto performed by various bodies and departments, but is seen as an important instrument in the development process, capable of playing a very non-traditional role in the restructuring efforts. In the case of the Bahamas, this perspective comes out to some extent in the Central Bank Law which we discussed earlier, but even more explicitly in the Independence White Paper to which we made reference in previous chapters.[61]

The above discussions have outlined in general terms the role of a central bank in a developing environment without going into too much details. It remains for us at this point to pin-point some areas in which an institution of this kind can be of some specific assistance within the framework of the nature of the problems facing the society and the powers and functions with which it is endowed, thus giving some indication of the kind of orientation that is possible.

In discussions on economic development, a commonly held view is that many developing countries suffer not so much from a shortage of capital, as from the inability to fully mobilise available resources and channel them into productive investment. This observation is particularly applicable to the Bahamas where not only are the avenues and incentives for savings very limited, but such savings as do take place through the intermediaries are used to finance activities which do not generally conform to the long term interest of the country. In this context, therefore, an essential role of the central bank will be (or at least should be) not only to create greater opportunities for private sector savings by encouraging the development of a wider range of financial instruments to meet the preferences of savers, but also to direct funds made available into socially desirable areas. An important task of the Bank would therefore be the re-orienting of existing financial institutions away from such traditional areas as trade and expatriate industry to more basic and lagging sectors like agriculture, fisheries, small industries, agro-based activities etc. The Bank itself, though not a development institution, is well placed with funds from different sources, (e.g. equity and surplus, commercial banks' reserves, and probably loan funds) which it could use for lending to priority sectors through the Development Bank or similar agencies concerned with expansion in the productive capability of the country. Other functions might include the training of personnel in financial operations and the encouragement of new local financial institutions appropriate to the development process.

Before going on to discuss the major techniques of credit control and their relevance in underdeveloped financial markets, the general perspective from which the scepticism over the role of a central bank in a dependent economy stems, should be briefly outlined. The approach adopted in the literature is by and large the conventional savings/investment Keynesian analysis which focuses on what are sometimes posited as the independent components of national income, viz., investment expenditure, government expenditure and exports.[62] Though the two latter aggregates can be regarded as outside the control of a central bank, the fact that domestic investment (normally drawing heavily on the resources of the financial system) forms a large component of national income in developed countries, permits the central banks in these areas to pay an active part in influencing income and employment by affecting the supply and price of credit in the money and capital markets, and hence influencing the decisions of investors and ultimately the level of demand.

In a dependent economy, on the other hand, where the export trade (or tourism) is the major generator of income and employment and the major influence on the money supply, monetary policy of the kind described above, which is concerned with the adequacy of domestic demand relative to existing productive capacity, is of limited relevance. However, some scope for smoothing out externally induced fluctuations does exist in the form of synchronisation in the use of foreign exchange between booms and recessions, and the excercise of some form of control over the liquidity of the public and the banking system. The latter operation, however, which is aimed essentially at controlling the volume of imports and foreign reserves, which quickly reflect any internal changes in income and the money supply, is essentially different from what is referred to as monetary policy in advanced countries.

II. Techniques of Monetary Control and their Relevance to the Bahamas

A common feature of most, if not all the statutes of the central banks set up in the post-war period, has been the inclusion of provisions enabling these institutions to use all the orthodox techniques of credit control associated with the developed countries, irrespective of their propriety in the context of existing institutional and financial frameworks. As we saw earlier, the legislation setting up the Central Bank of the Bahamas is no exception in this respect. As far as the feasibility of these methods in this latter country is concerned, the relatively high level of monetisation attained by the economy is certainly a factor that would assist central banking operations. We shall see in the following sections, however, that given the structure and functioning of the economic system discussed earlier, and the absence of certain conditions or pre-requisites, controlling the money supply in the Bahamas with the 'tools' used in the developed countries, faces the same kind of problems that are now widely recognised in emerging economies. If anything, the situation is made more complicated by the 'financial haven' status of the country, which encourages the frequent and sometimes large scale movement of refugee and speculative funds which can have unpredictable effects on the liquidity position of the financial system and the economy. As indicated earlier, the inter-connection between some banks and non-bank institutions is another factor that has to be borne in mind, particularly in a situation where the central bank is equipped to deal mainly with the commercial banking sector.

The more conventional methods which evolved in industrial countries are discussed first. These include re-discounting, open market operations, variable reserve requirements and moral suasion. Another instrument which has been added to the arsenal of many of the new central banks is selective and direct credit controls which are also briefly outlined. In the final sections, the focus is on two unconventional methods, viz., import deposit requirements and exchange commission charges which have been used with some success, in combination with other techniques, particular in developing countries, where measures aimed at influencing conditions in money and capital markets may have little relevance.

The Bank or Discount Rate

Changes in the discount rate was the major instrument of credit control employed by central banks prior to the First World War, and is still an important technique (though in altered forms) in countries with independent and integrated financial systems. Though normally found in the statutes of central banks in developing countries, its use tends to be highly limited and circumscribed for reasons that will be explained shortly.

The discount rate[63] (or the Bank Rate as it is called in the United Kingdom) refers to the rate at which a central bank is prepared to make credit available to the commercial banks through discounts and advances. A change in this rate is the signal for a change in the whole spectrum of short term money market rates, which in turn, is expected to affect the total volume of credit and ultimately such variables as investment, income and prices. Influencing internal supply/demand money conditions, however, is not the only objective for which a change in discount rate policy can be used. As a mechanism for influencing the movement of short term capital across national frontiers, it is also very well known in the context of dealing with balance of payments problems arising from disturbances in the capital account.

From what we have said above, it is clear that the effectiveness of the discount rate technique in influencing the supply of money (and ultimately the level of domestic activity) is predicated on a number of assumptions, the most important of which is that there exists a finely tuned responsive money and capital market with the central bank at the apex, standing ready as lender of last resort in an emergency situation. It also assumes (in the absence of power by the central bank to directly influence the rates) that the commercial banks are habitual borrowers or re-discounters[64] at the central bank,[65] and that there is in the portfolios of the banks, a sufficient volume of instruments acceptable to the central bank for re-discounting or for use as collateral. Another requirement of some importance is that the banks operate on cash reserves sufficient for ordinary occasions,[66] so that any unusual demand for credit which cannot be satisfied from internal sources will force them into seeking accommodation at the central bank.

Viewed in the context of a country with an undeveloped money market and a limited volume and range of discountable instruments, the irrelevance of the discount technique becomes quickly apparent. It is even more severely limited in a situation where the banks do not maintain any fixed cash-deposit ratio and where the banking system comprises the branches of international concerns to which the local offices have easy access in time of cash need. With the break-up of the Sterling Area and the instability which has crept into the international exchange rate system, this latter factor would assume less significance, as the banks would be more inclined to seek domestic sources of funds, and, in this context, the position of the central bank should be enhanced, provided there exists sufficient paper for discounting or collateral purposes, and the discrepancy in cost between foreign borrowing and central bank accommodation is not too great.

Manipulating the discount rate as a means of bringing about changes in other short term money market rates is not an end in itself, the main objective being to influence the cost of credit in an effort to affect domestic economic activity. The assumption underlying this operation, therefore, is that the interest rate is an important if not critical factor in the investment decision — an assumption that has been questioned both in developed and developing countries. Of course, the significance of interest rates in this context, would tend to vary from investor to investor since considerations like the proportion of interest in total costs, and the ability to pass on this cost would exert some influence on the demand for funds.[67] Thus, in a situation where investment is financed from internal savings rather than from borrowing on the open market, or where foreign investment is the main mover of the economy, changing the local discount rate is not likely to produce any significant effect on domestic activity.

From what we have said above, and from some of our earlier discussions, it is clear that the internal function of the bank or discount rate in mitigating economic fluctuations would tend to be extremely limited in a developing country like the Bahamas where foreign capital plays such as a preponderant role in the economy. Such factors like the local inter-bank market and access to Euro-currency funds will no doubt also affect the efficacy of the discount weapon. With respect to the latter factor, which also has a bearing on the relevance of some of the other traditional central banking 'tools', we need to make a few comments in order to avoid any misconceptions about its role in domestic monetary management.

In the last chapter, we pointed out that in countries where financial institutions are free to switch funds in and out of the local currency, and where there is generally little control over lending activities, serious problems are posed for monetary and exchange rate policies. The concern in this connection derives to a great extent from the fact that participants in the Euro-currency markets are able to mobilise and dispose of funds in large amounts, and at fairly short notice, in a system which is generally free from any kind of national or international controls. In the context of the Bahamas, we have already indicated that financial institutions function within a defined set of regulations which in a large measure tend to insulate their domestic activities from their external operations. Despite this, however, there are indications that the banks, at least, are able at times to by-pass the official regulations and draw on foreign funds. To the extent that they can do this, the 'lender of last resport' need not be the central bank or even the traditional 'Head Office', but the Euro-currency markets in which the authorised dealers participate as autonomous units, without apparently much direction from head office.

Open Market Operations

Open market operations refer to the buying and selling (in the open market) of various kinds of commercial paper by the central bank with a view to affecting conditions in the credit market via changes in the reserve positions of financial institutions, particularly commercial banks, or to influencing the level and structure of interest rates. Although it is only one of the several means available to the central bank for altering the total of its assets, and hence of its liabilities,[68] it is among monetary control weapons in countries with a developed money market the most potent, by reason of its ability to influence not only the volume of banks' reserves, but particular maturity sectors of the loanable-funds market.[69] The range of instruments in which the Bank is normally permitted to deal is generally very broad and comprise such assets as bonds, corporate securities, bills of exchange and government obligations, the latter normally providing the major medium through which operations are carried out.

Open market operations by its very nature, is a very flexible technique in that it can be applied in varying dosage and its direction can be quickly reversed, but its applicability and success (efficacy) depends on a number of factors which are generally not present in developing countries. The first requisite which is necessary to avoid large fluctuations in the prices of securities is an active and broad money and capital market, broad taken here to imply the presence of three features: (a) a large number of buyers and sellers with a high average frequency of transactions; (b) the presence of position takers; and (c) a wide spectrum of owners and ownership motives.[70]

Porter argues that while attribute (a) is hardly to be expected in markets of small or poor countries, the latter two which are probably much more important, need not be absent.[71] A second requisite which is closely related to the first, and which, in fact, might be termed a pre-condition, is the availability of securities in sufficient volume and in various maturities to meet the demands of economic units including the central bank. There are two other conditions which contribute to the success of open market operations, though it is contended that these are not absolutely essential if there is a broad and active security market.[72] The first one is that banks should adhere to a more or less fixed cash/deposit ratio, changes in which should have an immediate and direct impact on the volume of loans. The other is that banks should not resort to accommodation from the central bank in order to replenish reserves depleted by open market operations. While the latter can be easily dealt with by the authorities through appropriate policies, a situation in which banks are accustomed to large fluctuations in their cash/deposit ratio, does not lend itself easily to influence through open market operations aimed at influencing bank credit, even if there is a broad and active security market, not to mention one where the latter does not exist. For various reasons related to the structure of the economy and the orientation of the institutions, the lending policies of commercial banks in dependent countries tend to be influenced more by such things as credit-worthiness and collateral, rather than by marginal changes in the cash/deposit ratio.

There are a number of advantages [73] to open market operations, which have made this control measure very popular in certain developing countries. One, to which we have already pointed, is its flexibility, in that operations in one direction can quickly be reversed in response to changes in money market conditions. A second advantage is that it can be carried out in small steps, in addition to the fact, of course, that it can be used continually to bring about changes in the reserve base of the commercial banks. A fourth and major advantage stems from the fact that open market operations can be undertaken at the initiative of the central bank unlike the case of discount rate changes where the central bank "can only encourage or discourage banks to borrow, but has no direct control of the volume involved".[74]

As far as the application of the open market technique to the Bahamas is concerned, the limitations are fairly obvious in the absence of a developed money and capital market and the related conditions discussed earlier. The fact that a broad and active market in government securities does not exist, means that the Bahamas Central Bank will not be able to undertake transactions of the size that may be required to affect the cash base of the banking system without disrupting the market. Besides this limitation, which is quite characteristic of the situation in developing countries, a further difficulty arises where the banking system operates on what might be called an 'excess liquidity' position as has been the case in the Bahamas over recent years. This position, of course, could normalise with an expansion in credit and/or an increase in the holdings of Government securities. However, in a situation where the banks apparently have facilities for increasing their reserves independently of the central bank, quantitative methods of monetary control operating through the cash base of the banking system is bound to encounter difficulties.

There is a further factor which we need to consider in the Bahamas. As a result of the country's narrow revenue base, the government has found itself increasingly resorting to domestic borrowing to finance its rising expenditures. In this situation, it clearly would be most anxious to maintain order in the Government securities market, and less willing to undertake any open market operations aimed at influencing the cost and availability of credit, and which could affect the stability of the market. In such circumstances, the central bank's involvement with Government debt instruments would tend to be aimed more at supporting public debt operations, than in their use for purposes of monetary management for which the scope is very limited.

Variable Reserve Requirements

The practice of requiring the commercial banks to keep a certain percentage of their deposits, either in till and/or on deposit with the central bank, has been a feature in the financial arrangements of several developed countries for many years. Such reserve requirements tend to serve two functions. Firstly, they can be used to ensure the liquidity or solvency of the banking system and secondly, by being made amenable to change by the central bank they can be transformed into an important instrument for the control of bank credit, and hence the money supply, by limiting the extent to which loans and investments can be increased or decreased as a result of changes in cash resource. An increase in reserves will normally be expected to lead to a contraction in lending, while a decrease would tend to provide a basis for further credit expansion. It should be pointed out, however, that a change in the reserve ratio does not necessarily guarantee a change in banking activities in the required direction, since there might be other factors influencing banking behaviour and demanding greater consideration, at least for the moment. For example, banks may choose to keep excess reserves in the absence of enough credit-worthy borrowers at a time when the central bank is seeking to expand domestic credit. On the other hand, in situations were the central bank is successful in restricting bank lending in a fight against inflation, achievement of this goal will depend on the adoption of supplementary measures e.g. control of budgetary deficits.[75]

To be an effective control tool, reserve ratios must, by definition, possess two characteristics. One, they must relate to excess or secondary reserves, i.e. reserves above what the banks require to meet their everyday or primary needs. Secondly, as pointed out above, they must be made subject to variation by the central bank.

Though variation in reserve requirements may appear as a rather simple technique to operate, in practice it is not frequently used, particularly in the upward direction. In general, it is regarded as a rather blunt, even if precise instrument which should be resorted to in extreme circumstances in which other techniques can make little impact, or depend for their effectiveness on the direct and immediate variation in bank reserves. One of the major objections advanced against its use is that it affects all banks 'immediately and simultaneously', thereby exerting the same severity on all banks, large and small.[76] Banks which are in different states of liquidity when the reserve requirements are changed will also tend to be affected differently. Another criticism levelled against this technique, is that by its selective application it tends to be biased in favour of banks and non-bank financial institutions not subject to reserve requirements, which are thus able to enjoy greater flexibility in their loans and investment activities, thereby enhancing their earnings capacity at the expense of their competitors.

Another weakness of the variable reserve technique is that it cannot be used for bringing about small changes in the volume of credit, and for this reason it is resorted to only when large changes in the liquidity position of the banks are desired. The fact, too, that an increase in reserve requirements may be made at very short notice, will require the banks to make fairly quick adjustments in their portfolio, which may result in losses being sustained, or earning power being reduced. For these reasons, this instrument is more an emergency measure not employed in day-to-day operation for which other techniques are better suited. Even if it were to be employed as a short term technique, the fact that the banks will try to minimise their adjustment problems by keeping excess reserves will soon render it useless as a control instrument. In the specific context of the Bahamas where the cash base of the banking system can be affected significantly almost on a daily basis by the movement of refugee and speculative funds, the technique becomes even more irrelevant.

Given the limited scope for open market operations in the absence of an organised securities market, it is natural that variable reserve requirements as the other technique available to the authorities for affecting the liquidity of the commercial banks at its own initiative, would find popular appeal in developing countries, notwithstanding the limitations we have outlined earlier. The effectiveness of the technique, however, pre-supposes the two following conditions. The first one is that banks determine their lending policy on the basis of their cash reserves; and secondly, banks are in the habit of maintaining reasonably fixed ratios between their deposits and cash balances.[77] It has been argued that in countries without developed money markets, banks tend to pay more attention to the availability of foreign funds and the ratio of advances to deposits rather than cash balances in determining their credit policy.[78] Against this, however, the view has been put forward that while a large number of factors do tend to exert considerable influence on the lending policies of banks, the state of their cash reserves is, by no means, a negligible or even a minor consideration.

Besides providing for cash reserve requirements, some legislations equip the central bank with power to stipulate minimum liquid assets ratios for the commercial banks, which can be used in the same way as cash reserves both for solvency and monetary control purposes. While providing a broader base for the control of the money supply, use of this concept also has the advantage of putting at the disposal of the government a larger volume of banks' resources when this objective is required.

Another concept sometimes used, mainly in the context of deterring short term funds from leaving the country, is what is known as the local assets ratio which is prescribed in relation to local liabilities.

Moral Suasion

Moral suasion can be regarded as a direct form of monetary control, even though it does not have any explicit statutory basis. It is purely an informal method operating through appeals, oral or written, and used by the authorities for securing the cooperation of the financial community in achieving certain desired goals which they feel could be attained without administrative compulsion. For very obvious reasons, the smaller the number of institutions to be dealt with, the more feasible and effective this instrument is likely to prove.

Given the existing conditions in the Bahamas, moral suasion is likely to be one of the most practical means of influencing the financial system which may not be susceptible to other methods of control having a legal basis. Where the commercial banks are concerned, past evidence suggests that relations between the latter and the authorities have always been good, and that regular meetings between the two have provided a useful forum for resolving many difficulties of common concern. While the lending practices of the banks have not generally coincided with the scale of priorities as seen by the Government (a question that urgently needs to be attended to) these institutions have always displayed a keen interest in the purchase of government securities, and, in this respect, they may be able to play and important part in the development of a local money and capital market.

Since the central bank may not have any control over non-banking institutions, which generally do not have access to its credit or which are not subject to its regulations, moral suasion can be a useful means of persuading such institutions in following a particular course in the interest of realising official objectives. Inability of the central bank, however, to resort to compulsory measures, or take punitive action in the event of non-compliance, considerably limits its power of moral suasion in dealing with these entities.

Direct Controls Over the Volume, Direction and Terms on Which Credit is Extended by the Commercial Banks

As indicated earlier, a common practice in monetary management is the use of moral suasion in efforts aimed at getting the support of financial institutions in implementing the policies of the central bank or the government in achieving broader and longer term objectives with which the activities of these institutions may sometimes be in direct conflict. In developing countries where resources tend to be scarce, it is the responsibility of the government not only to see that available funds are optimally utilised, at least in a general sense, by discouraging investment or credit in certain areas (which may be profitable from a private point of view, but which hold little value for the development of the country), but also to encourage the flow of resources along lines that could add to the productive capacity of the country. Besides this qualitative (selective) aspect to the control of credit, the central bank may also desire to have limits placed on the volume of loans made to particular sectors or industries, and may even go so far as to suggest acceptable collaterals.

In circumstances where commercial banks enjoy certain privileges with the authorities (e.g. discount facilities), the chances of cooperation are much better, than in a situation where the banks are self-reliant or almost so, and it has therefore become necessary in several countries to equip the central bank with the power to regulate credit in the forms we have described. As a means of discouraging speculative and inflationary lending patterns, this technique of direct control has been found to be very effective, particularly when used in complement with other methods of control.

Advance Deposit Requirements for Imports

The device of requiring advance deposits on imports was first conceived as a means of controlling or discouraging imports by imposing an added financial burden on the importer.[79] Subsequently, it was discovered that the measure could also be used as a technique of monetary policy, particularly in countries where some of the conventional methods of control are of little or no relevance because of the absence of an organised money market.[80]

The exact arrangements employed vary from country to country, but, essentially, the device consists of requiring the importer to deposit with the central bank,[81] funds amounting to a certain percentage of the value of the product to be imported, for a specified period of time, after which the money is returned to the importer. The compulsory payment is normally stated in national currency, though in some cases foreign exchange may be permitted. The percentage of the value of the import required tends to vary from country to country, but, generally, the pattern calls for minimal requirements on essentials rising to higher proportions on 'semi-luxury' and 'luxury' goods.

As a means of restraining imports, compulsory advance deposits have certain advantages over other conventional means such as tariffs, quantitative restrictions and multiple exchange rates normally employed for this purpose. For one thing, the technique is relatively easy to administer and when changes in the level of deposits are required, legislative approval may not have to be sought, as is the case with some other measures, where the approval of international organisations like the General Agreement on Tariffs and Trade (GATT) or the International Monetary Fund (IMF) has to be obtained.[82] For another, while the technique is not a revenue raiser like, say, tariffs, it does place in the hands of the authorities resources which could be used to finance government expenditure. In fact, in certain countries (e.g. Chile), government obligations can be purchased in place of cash advance deposits. The effectiveness of the tool, it should be noted, if the aim is to control imports in order to prevent a drain on foreign reserves, depends on the non-availability of finance to meet the pre-deposit stipulations. If the state of the market is such that importers can readily obtain funds, the effectiveness of the technique in relation to the balance of payments objective stated would have been lost. In this connection, one writer has expressed great pessimism about the applicability of the technique under Caribbean conditions, given the nature and organisation of the import business and the orientation of the commercial banks which may have little hesitation in making the necessary credit available in the absence of any monetary constraints.

> *Firstly, such loans would be virtually riskless, since the deposit itself guarantees the loan. Secondly, importing houses are given much preferential treatment in obtaining credit. Sometimes this is due to their size and importance in the mercantile and the general community. In other situations, it may be due to the fact that liens on the goods imported constitute an excellent collateral, or that the credit demands of importers (inventory financing) to a great extent match the lending preferences of the commercial banks. Thirdly, many of these importing houses have a long association with foreign exporting firms, and, therefore, may find it possible to obtain this credit externally, Fourthly, in the case of both domestic and external credit (or indeed resort to financial resources internal to the firm), the larger import houses are not nearly as much discriminated against as are the smaller ones.*[83]

The main point that emerges from these observations is not so much that the compulsory deposit tool is altogether inappropriate in the Caribbean as its application must be accompanied by a curb on commercial banks lending (directly or indirectly) to the extent that the latter is a critical factor to its effectiveness.

In the foregoing paragraph, we discussed advance deposits, principally as a means of controlling the volume of imports in the context of conserving foreign exchange resources. As indicated earlier, the technique can also be used as an instrument of monetary policy through the absorption of liquidity in times of over-supply, and its release in periods of scarcity, thus offsetting cyclical fluctuations in money income arising from changes in the balance of payments. The initial impact of deposit requirements falls directly on the importer who is faced with an added cost which may have to be met from internal sources to the extent that funds are available, or by borrowing from commercial banks which specialise in short term credit. In the former case spending power is correspondingly reduced, while in the latter the liquidity of the banking system (and hence its credit creating ability) would be affected since loans granted for pre-deposit purposes are sterilised for the duration of the regulation.

One of the arguments normally advanced against the technique is that the release of the accumulated deposits may have any inflationary effect upon the economy. The solution to this problem, it is suggested, would be to coincide the dismantling of the arrangement with a deflationary period, thus injecting a liquidity element into the system, which can serve as a base for further credit expansion. It is also contended that a curb on imports may have an upward effect on internal prices, if demand cannot be satisfied from domestic production. If conservation of foreign exchange is the objective at the time the regime of advance import deposits is instituted, then an increase in domestic prices may have to be accepted as part of the cost toward this end.

It is clear from the above discussion that while pre-deposit requirements may have wide application as an instrument of monetary policy, its use as a means of conserving foreign exchange through encouragement of greater local consumption would tend to be highly limited in a country dependent for almost all its supplies on foreign sources, as is the Bahamas. As the potential for domestic production increases, however, the technique can be used to discourage imports on a selective basis with a view to encouraging greater local output of competitive goods.

Variation in Currency Conversion Commissions

As indicated earlier, in circumstances where the money supply and other economic conditions tend to be significantly influenced by balance of payments factors, not much can be accomplished in terms of monetary management by operating on internal variables such as the cash ratio and the level of interest rates. As a result, attention often tends to be concentrated on more direct measures such as the exchange control regulations in order to influence the movement of funds into and out of the country concerned. In this context, one device which is often used, and which has an effect similar to a change in the exchange rate, is variation in the external transfer charge which can be increased if the intention is to discourage the outflow of funds (i.e. foreign currency becomes more expensive to purchase), and decreased if an inflow is desired. The relevance of this technique as a control instrument depends, of course, on the extent to which the charges are, in fact paid, since a variety of ways exist for obviating this added expense.

In some countries (e.g. Jamaica), changes in the commission charged on sales of foreign exchange have often been used to pursue an independent interest rate policy. For example, when the British bank rate is increased, the local rate can be kept steady, while the external transfer charge is raised to avoid an outflow of short term funds to London.

Concluding Observations

It is generally agreed that while central banks in developing societies can perform many of the functions that have been traditionally entrusted to their counterparts in the developed countries, their major role in the former context must of necessity be a development one. Because of the existence of certain basic conditions, the use of the major traditional techniques of monetary control tends to be highly limited. In the specific context of the Bahamas, the efforts of the central bank can usefully be directed to the development of the local capital market, encouraging savings, assisting the growth of indigenous financial institutions, providing guidance in the establishment of a sound financial infrastructure and directing credit into productive channels. As a Government-owned institution, the Bank has to operate in reference to the broad objectives set out by its owner, but these objectives, themselves, may need to be informed by the skill and expertise which the bank will acquire in the course of time.

FOOTNOTES

1. For a brief note on the currency situation before this date see Craton, *op. cit.*, p. 304.
2. See chapter on Commercial Banking.
3. Act 2 Vic. cap. 4.
4. Legislative Authority. Her Majesty's Proclamation of 19/2/1853.
5. Legislative Authority: Governor Bayley's Proclamation of 6 April, 1864.
6. Legislative Authority: Her Majesty's Proclamation of 14 September, 1838.
7. Though some of these were imported or brought over by private persons, the Royal Bank of Canada was responsible for the bulk of them entering the country. It should be noted that though these notes were never made legal tender, they were received and paid out at their face value.
8. In order to fill the vaccum created by the withdrawal of the notes issued by the Bank of Nassau, two possibilities were explored by the local Governor before the decision was raken to issue local currency. One was to import English currency notes – a proposition which was coldly received by the British Treasury which had no hesitation in suggesting a Government Note Issue. The second was to induce the Royal Bank of Canada to issue its own notes. The latter argued it could not do so without the authority of the Dominion Government, though there was some doubt that this was the case for notes of £1 or less. From the correspondence one detected an element of reluctance on the part of the Royal to issue notes in the Bahamas, particularly since they were doing so in some other West Indian Territories.

   In the midst of all the discussions, the House of Assembly passed a resolution in favour of a legal tender currency based on a decimal system, and set up a select Committee to "bring in such bills as may be necessary to give effect to the decision by the House . . ." As we shall see later, however, a decimal system was not to come until almost half a century later.
9. Sterling money (or at least the local verson of it), however, continued being the money of account until 1965.
10. British silver coins in circulation in 1935 totalled some £23,000 as compared to the local note of £73,400.
11. As indicated in Chapter 2, United States' currency appears (at the moment, at least) to form a relatively small part of the total Bahamian money supply. It might be noted, however, that in certain politically independent countries *(viz.* Panama and Liberia) foreign (American) currency functions as legal tender and tends to form the bulk of the money in circulation in these states. For a discussion of the implications of such arrangements (which resemble, in important respects, the Currency Board system with a 100 per cent foreign backing), see H.G. Johnson, "The Panamian Banking System", *Euro-money,* January, 1972. See also M. Anado and A. Porteri, *The Banking System and the Formation of Savings in Lesotho*, Milan, Cassa Di Risparmio Delle Provincie Lombarde, 1974 which discusses the position with respect to Lesotho which is dependent on South Africa for its monetary arrangements.
12. While the Bahamas Currency Board was located in Nassau, the Boards of some other countries were sited in London.
13. It should be noted that the major arrangements reflected in the West African Currency Board System, themselves, had precedent (in varying degrees) in a number of countries where private institutions were unwilling to assume responsibility for the issue of local notes. These included Mauritius where a Government note issue was introduced in 1847 on the condition that it was to be covered by sterling; the Falkland Islands which got a similar system in 1899; and the Straits Settlements where a Government note mechanism was set up in 1906 involving formal convertibility into sterling in London (See Alexander McLeod, "The British Currency Board System – Successes and Shortcomings", *The Banker,* March 1975).

    As a matter of interest it might be pointed out that the Currency Note Act introduced into the

Bahamas in 1919 was identical to the Falkland Islands' Currency Note order of 1899, except for minor changes made to reflect local conditions.

14. The system, however, was not an exclusively British manifestation. See A. McLeod, *op. cit.*

15. For a brilliant review of the literature see C.Y. Thomas, *Monetary and Financial Arrangements in a Dependent Monetary Economy*, Institute of Social and Economic Research, U.W.I.

16. The corresponding provision in the 1919 law, it should be noted, obliged the Board to exchange local currency notes for gold and silver coins which were circulating in large quantities (the latter particularly) as legal tender at the time. Since holders of notes were also entitled to demand coin (gold or silver at the option of the Commissioners) in exchange for their notes, it was necessary that all receipts of coin arising from currency transactions be placed in a fund (the Note Guarantee Fund) for meeting exchange obligations (See Table 6.2). In the 1936 legislation, the Note Guarantee Fund was superseded by the Note Security Fund which was nothing more than a new name for an old account.

17. Section 6, *The Currency Note Act*, 1936.

18. While a fiduciary issue (that part of the currency backed by local government securities) was permitted some countries in the middle and late '50s, no such provision was made in the Bahamas regulations until 1965, when the government acted to reduce the currency reserves to a level equal to 50 per cent of the note circulation.

19. Shortfalls in the backing were to be met from the general revenue of the country.

20. Section 7 (3) of the 1936 Currency Note Act.

21. For a detailed discussion on the implications for the money supply of different types of bank responses, see C.Y. Thomas, "The Balance of Payments and Money Supplies of a Colonial Monetary Economy", *Social and Economic Studies*, March, 1963.

22. C.V. Brown, *The Nigerian Banking System*, London, George Allen and Unwin Ltd., 1966, p. 52.

23. E. Nevin, *Capital Funds in Under-developed Countries: The Role of Financial Institutions*, New York, Macmillan & Co. Ltd., 1963, p.8.

24. The rate of exchange was fixed by the Secretary of State in the British Government.

25. For an interesting theoretical discussion of the factors influencing the movement of capital in certain Latin American countries, see Rudolf F. Rhomberg, "Private Capital Movements and Exchange Rates in Developing Countries" in J.H. Adler (ed.), *Capital Movements and Economic Development*, New York, St. Martin's Prress, 1967.

26. When sterling was devalued on 18 November 1967, the Bahamian dollar which was legally tied to that currency was automatically devalued by the extent of the U.K. devaluation, i.e. by 14.3 per cent. A decision was, however, taken to restore the relationship between the Bahamian dollar and the U.S. dollar by revaluing the former to 8 shillings and 2 pence sterling, with effect from 21.30 hours GMT on Saturday, 18 November, 1967. The par value of U.S. \$0.98 = B\$1.00 continued until 2 February, 1970 when, as a result of a change in the gold parity of the local currency, a new rate was established at U.S. \$1.00 = B\$ 1.00, or B\$ 2.40 = £1.00. Following the suspension of the U.S. dollar convertibility into gold, tradition was broken on 27 August, 1971 when the Bahamian dollar was pegged to the U.S. dollar at B\$ 1.00 = U.S. \$1.00 instead of to sterling. This arrangement continued until 23 December, 1971 when the peg with sterling was reinstated, this time at B\$ 2.5275 = £1, but not before the local currency was devalued by 5.05 per cent (as compared to the U.S. devaluation of 7.89 per cent) which brought back the official parity in terms of the U.S. \$ to B\$ 0.97 – a rate which prevailed for the rest of 1972, notwithstanding the floating of sterling in June of that year. During 1973 and 1974, there were further developments, particularly in the context of the floating of major international currencies. During 1974, the central bank "was prepared to buy the U.S. dollar at par and sell at the rate of 1.005. The rates which were applied to transactions against sterling varied considerably. On 1 January, the rate at which the central bank was prepared to buy sterling was \$2.3212 = £1. There was a rise to \$2.1712 = £1 on 21 January. The rate fell to a low for the year of \$2.4360 = £ on 6 May. After this the rate fluctuated upwards towards the end of the year to \$2.346 = £1. Rates at which the central bank was prepared to sell sterling were the same as the buying rates plus 0.5 per cent" (1974 Central Bank Annual Report).

27. Section 4 of the Currency Act, 1965.

28. More precisely the U.K. Government agreed that in the event of the middle sterling/U.S. dollar rate in London falling, and remaining for thirty consecutive days, below \$2.3760 (1 per cent below the parity of \$2.40 ruling when the agreements were concluded), a payment in sterling

would be made to restore the dollar value of officially-held sterling exceeding 10 per cent of each country's total official external reserves.

29. *Proposals for a Monetary Authority,* (White Paper) by the Minister of Finance, 1968, p. 11.

30. *Ibid.*

31. S.W. Payton, *op. cit.*

32. See L.O. Pindling's booklet *Building a Nation Through Peace, Understanding and Love, op cit.*

33. Clive Thomas, *The Structure, Performance and Propsects of Central Banking in the Caribbean, op. cit.,* p. 6.

34. Upon establishment of the central bank, it was arranged that the capital of the BMA would be transferred to the former, any deficiency in authorised resources being paid from the Consolidated Fund at such times and in such amounts as the Board of Directors with the approval of the Minister of Finance may determine. Unlike the BMA legislation, the Central Bank Act does not stipulate a minimum paid-up capital.

35. Section 25.

36. 'Ordinary revenue' is defined as all income or contributions to Government revenue not being loans, capital grants or other receipts of a capital nature. 'Average ordinary revenue' means the annual average of ordinary revenue over the three years (preceding the year of calculation) for which accounts have been laid before Parliament; 'estimated ordinary revenue' means the ordinary revenue as estimated in the estimates in the Government as laid before Parliament for the year.

37. Section 26–(2).

38. See the central bank's Annual Report for 1978.

39. The comparable period for the other directors is four years.

40. First Schedule, Section. I.

41. Net profit is defined as the residual after deductions and allowances for other reserves and contingencies have been made.

42. Besides the regular procedure set out here, the Minister can ask the Auditor General to look into any aspect of the Bank's operations whenever he so desires.

43. See M.H. De Kock, *Central Banking,* London, Staples Press Ltd., 1952, p. 95.

44. For an interesting statistical analysis in which he shows the level of foreign reserves to be positively correlated with such variables as the import coefficient, variability of international receipts and payments and the level of imports, see J.S. Frenkel, "The Demand for International Reserves by Developed and Less-Developed Countries", *Economica,* February, 1971.

45. A very convenient reference work for purposes of comparing the legislative provisions of a number of central banks is Hans Aufricht, *Central Banking Legislation,* Washington, D.C., IMF, 1961. For a survey of practices followed by African countries see S.K. Basu, *Central Banking in Emerging Countries,* London, Asia Publishing House, 1967.

46. De Kock, *op. cit.*, p. 65.

47. Section 65 (1) and (2) of the Monetary Law Act, No. 58 of 1949.

48. Section 25 (2) of the Central Bank of Barbados Act, 1972. Section 26 (3) continues: "if the Reserve of External Assets has declined, or in the judgement of the Board appears to be in danger of declining, so as to jeopardise the adequacy of such reserve, the Bank shall submit to the Minister a report on the reserve position and the causes which have led to such a decline, together with its recommendations concerning the measures it considers necessary to forestall or otherwise remedy the situation".

49. These are set out in that country's Monetary Law Act, *op. cit.* (Chapter 2: Part 1, Sect. 5) as follows (a) the stabilisation of domestic monetary values; (b) the preservation of the par value of the Ceylon rupee for current international transactions; (c) the promotion and maintenance of a high level of production, employment and real income in Ceylon; and (d) the encouragement and promotion of the full development of the productive resources of Ceylon. The legislation is reproduced in Hans Aufricht, *op. cit.*

50. For an excellent discussion on these views, discussed in relation to economic growth as an objective of monetary policy, see C.R. Whittlesey, "Relation of Money to Economic Growth" in the *American Economic Review,* May, 1956. Papers and Proceedings of the 68th Annual Meet-

ing, of the AEA.

51. For an elaboration, see H.S. Ellis reply to Whittlesey, *op. cit.*

52. This question is, of course, an old one which poses many difficulties in practice. A technical reply provided by Harry Johnson to the problem of the extent to which monetary expansion can be used to finance development without inflationary consequences is "the limit set by the growth of demand for money consequent on the expected growth of the economy at stable prices, plus the growth of demand for money associated with the monetization of the subsistence sector (where relevant), minus the portion of the growth in the money supply that must be created against private debt".

["Is Inflation the Inevitable Price of Rapid Development or a Retarding Factor in Economic Growth", Paper presented at the *Third Rehovoth Conference on Fiscal and Monetary Problems in Developing States,* August, 1965].

53. It is not our intention here to get into the pros and cons of inflationary financing. It is, however, worth pointing out that there are many economists (e.g. H.G. Johnson) who have come to regard some degree of inflation as an inevitable concomitant of resource mobilisation within the framework of a developing society. Once the rate of price increase is not at level that can seriously affect expectations about the value of the currency and, hence, induce an undesirable allocation of resources, it is argued, inflation can serve to bring about a redistribution of income in favour of groups with a higher propensity to save (if this is a desirable objective) as well as to increase the flexibility of the authorities in the reallocation of labour and resources as between one sector and another in the restructuring process.

54. See W.C. Allen, "Inflation in the Bahamas", in Compton Bourne (ed)., *Inflation in the Caribbean* (Institute of Social and Economic Research, 1977), p. 113.

55. See for example C.Y. Thomas, *Central Banking in the Caribbean, op. cit.*, p. 15.

56. Freely convertible foreign currency' is defined to mean "any foreign currency which at the time in question is in the opinion of the Bank a currency that is freely negotiable and transferable in international exchange markets at exchange rate margins consistent with the Articles of Agreement of the International Monetary Fund".

57. 'Money at call and demand balances at any financial institution' means "money at call and demand balances held by any commercial bank at any financial institution less money at call and demand balances held at that bank by any financial institution". In other words, the item is to be considered in a 'net' sense.

58. This point should not be easily dismissed because of what appears to be a relatively low ratio of non-bank financial assets to the total of bank and non-bank financial assets. The figure for the Bahamas is around 0.30 as compared to 0.64 for Guyana, 0.54 for Trinidad and 0.55 for Jamaica. (See C.Y. Thomas, *Central Banking in the Caribbean, op. cit.*, p.55). As we have indicated earlier, for a number of reasons, important segments of the Bahamian financial sector have long been exporting their funds which are not reflected in our ratio which only takes account of B$ assets, and, therefore, does not give a true indication of the importance of the non-bank sector in the financial structure.

59. See Hans Aufricht, *op. cit.*

60. The Central Bank of the Bahamas has so far been able not only to cover its costs of operations, but make a profit in every year since its inception. Profit from operations has been as follows:

Year	$m.
1974	6.1
1975	6.4
1976	3.8
1977	3.4
1978	4.1

61. See especially paragraphs 101 to 104.

62. The other component of national income *viz.*, consumption expenditure is more a target of fiscal policy than monetary policy. Both combined, amount to what is sometimes referred to as contra-cyclical policy.

63. While in countries with developed money markets one rate is quoted, it is not uncommon to

find, in countries wishing to discourage or encourage certain lines of credit, several different rates depending on the kind of paper discounted or the collateral offered.

64. It should be pointed out that this condition is not necessary in circumstances where the institutional arrangements are such that a change in bank rate is followed by a similar change by the commercial banks, which may feel morally obliged to support the policies of the central bank, even though they are not dependent on it to any great extent.

65. S.N Sen, *Central Banking in Undeveloped Money Markets,* Calcutta; Bookland Private Ltd., 1967, p. 38, 4th ed.

66. *Ibid.*

67. For an elaboration on this theme, see L. Best and A. McIntyre, "A First Appraisal of Monetary Management in Jamaica", *Social & Economic Studies,* Vol. 10, 1961.

68. See G.S. Dorrance, "The Instruments of Monetary Policy in Countries Without Highly Developed Capital Markets", *IMF Staff Papers,* Vol. 12, 1965.

69. J. Ascheim, *Techniques of Monetary Control,* Baltimore; The John Hopkins Press, 1965, p. 12.

70. Richard C. Porter, "Narrow Security Markets and Monetary Policy: Lessons from Pakinstan", *Economic Development and Cultural Change,* Vol. XIX No. 1, October, 1965.

71. *Ibid,*

72 Sen. *op. cit.*, p. 53.

73. See Thomas Mayer, *Elements of Monetary Policy,* New York, Random House, 1968, pp. 25–26.

74. *Ibid.*

75. See R. Goode and R.S. Thorn, "Variable Reserve Requirements Against Commercial Bank Deposits", *IMF Staff Papers,* 1959-60.

76. Chairman of the Board of Governors of the Federal Reserve System quoted in Ascheim, *op. cit.,* p. 20.

77. B.A. Plumptre quoted in Sen, *op. cit.*, p. 86.

78. *Ibid.* p. 86.

79. This was the major objective behind the introduction of the technique in many Latin American countries which were forced to remove many of the more conventional controls over current transactions, under IMF pressure.

80. For a discussion on this aspect, see J.O.W. Olakanpo, "Monetary Management in Dependent Economies", *Economica,* 1961. See also Jorge Marshall, "Advance Deposits on Imports", *IMF Staff Papers,* Vol. VI, 1957-58.

81. Where the deposits are required to be made in a commercial bank, the latter is required to keep 100 per cent reserves against them for obvious reasons.

82. E.A. Birnbaum and M.A. Qureshi, "Advance Deposits for Imports", *IMF Staff Papers,* 1960.

83. C.Y. Thomas, *Central Banking in the Caribbean, op. cit.,* p. 17.

CHAPTER 7

TAX HAVEN STATUS AND ECONOMIC POLICY

Introduction

Taken literally, the word 'haven' means "a bay, recess or inlet of the sea, or the mouth of a river that affords anchorage and shelter for shipping".[1] Used figuratively, it connotes a 'refuge' or 'place of safe retirement'. Following from this latter usage, the term 'tax haven' has come to mean a place to which one goes (as a resident) or which one uses, in order to avoid taxes or to reduce one's tax liability.[2] With the emergence of 'offshore financial centres', a term associated with a particular type of administrative arrangements, Thomas Kelen has made a useful distinction between this facility and a tax haven.[3] The latter, he defines as a territory where assets can be held and profits can be accumulated and transferred without any local tax consequence, or at least, where such transactions precipitate a substantially smaller tax liability than they would have done elsewhere. An 'offshore financial centre' on the other hand, is seen as a place where international financial business can be carried on in a fiscally neutral way. The most distinguishing feature in the latter case is the separation of the domestic and international markets by the intelligent use of foreign exchange control and taxation.[4] A location, of course, can be both a tax haven and an offshore financial centre, and this is often the case because the regulations, laws and general conditions that define each tend to be related to some extent.[4]

It should be pointed out that the offshore financial centre is a relatively new concept (device) in international finance. It tends to be used more as a conduit (or 'window'), and in this sense, it differs from the traditional centres like New York, London, or Zurich[5] which form a genuine international intermediary function between lenders and borrowers of all nationalities. A number of factors combine to give the latter this distinctive feature. One is a high level of domestic savings. Another is the status of their respective currencies and the underlying economic and financial policies affecting their role in international transactions. A third is a highly developed money and capital market which is important in terms of, not only encouraging local savings, but in attracting foreign funds. A fourth relates to the conscious decision not only to allow foreigners to invest or place funds in the local market, but to be able to borrow there as well.

Tax havens, on the other hand, are by no means a novel feature of the international financial scene. The post-war period, however, has witnessed an unprecedented growth in their popularity, due more, it is true to say, to factors outside their sphere of influence than to any deliberate radical reorganisation or innovation in the traditional inducements structure. One of the most important of these factors has been the growth of taxation in some of the more affluent countries of the world. Another has been the controls and regulations of various kinds instituted by a number of countries in pursuit of certain national goals relating to the attainment of equity in the fiscal structure and the prevention of erosion in the tax base.

The facilities offered by tax havens provide both individuals and corporate entities with a legitimate means of avoiding or mitigating the impact of fiscal measures imposed by their home governments. In this connection, experts tend to make a sharp distinction between a situation involving evasion and one amounting to avoidance. While the former connotes a criminal breach of the tax laws, the latter refers to the "lawful disposition of one's resources in such a manner as to reduce the tax burden falling upon them"[6] Besides the purely tax avoidance aspects, of course, havens offer many opportunities in the areas of finance and investment as we have seen earlier. And, while much of these activities are quite legitimate, the facilities which these countries provide are often used by international swindlers in a wide range of illicit operations which have contributed, in no small measure, to the notoriety of many well known 'sanctuaries'.[7]

Every tax avoider – and there is a wide range of them – has his or her own peculiar needs to be met, or his or her own perceptions as to what constitutes an attractive haven. In the same way, while there are some features common to most tax havens, each tends to have its own particular attractions of both a natural and institutional character. For example, while some jurisdictions can offer a total absence of any major direct taxes (or taxes at very low rates), others are able to provide these same incentives along with an appealing living climate and tourist attractions such as beaches, clubs and so forth. Other factors such as communications, political stability, secrecy provisions, exchange control regulations, double taxation arrangements, the existence of financial infrastructural requirements and the availability of competent professional services also help to discriminate between tax havens. Increasingly, because of the financial pressures to which most modern governments are subject and the consequent need to spread the tax net in order to raise revenue, many experts tend to categorise tax havens in terms of those whose governments have given an explicit undertaking against the introduction of certain fiscal measures, and those who have not. Though the PLP administration has pledged itself to maintaining the tax haven status of the country, it has given no blanket guarantee in terms of a time frame or against the introduction of specific devices. Under certain legislations, however, (e.g. the Hawksbill Creek Act, the Industries Encouragement Act and the Hotel Encouragement Act) licensees or approved enterprises are assured of certain defined reliefs.[8]

No-tax or low-tax centres are not concentrated in any one corner of the globe. They spread all the way from Hong King and Singapore in the far

East to Liberia in Africa, to Switzerland in Europe and to Panama, the Cayman Islands and the Bahamas in the Western Hemisphere. The actual number in existence it is difficult to say, since the question of definition would be critical in any such exercise.[9] Doucet and Good, however, discern four categories into which tax havens can be classified.[10]

First, there are the traditional tax havens with virtually no taxes at all,[11] such as the Bahamas, Bermuda and the Cayman Islands. Second, there are those havens which impose taxes, but do so at a relatively low rate. These include the British Virgin Islands and Jersey. Third, there are the havens which tax income from domestic sources but exempt all income from foreign sources. Included in this category are Hong King, Liberia and Panama. Fourth, there are those countries which allow special privileges. These include some countries which are not generally considered to be tax havens, such as Luxembourg and the Netherlands.[12] These countries are usually suitable as tax havens only for limited purposes.

We might add as a footnote that there are certain jurisdictions which have attained a reputation for attracting a particular type of business. A prime example, in this regard, is Liberia where a large part of the world shipping tonnage is registered to bypass the stringent regulations and taxes in the country of real ownership. In our discussion on the insurance sector, we pointed out that Bermuda is favoured for the setting up of offshore captive insurance companies. Because of certain tax arrangements governing holding companies, Luxembourg has proved to be very attractive as a centre for this type of entity. Switzerland is best known for its secret bank account facility. Traditionally, the Bahamas has attracted a wide range of business, though in more recent years, it has become best known as a centre for offshore banks and trusts and as a functional location for the conduct of the international currency business. In order to increase the appeal of the Bahamas as a tax haven, the Government has recently passed legislation designed to attract offshore captive insurance companies and to make this country a centre (similar to Panama and Liberia) for the registration of foreign going ships. It is not yet possible to assess the effects of these measures on the volume of tax haven business.

As a matter of interest and for purposes of comparison, the tax situation obtaining in some of the major tax havens of the world is presented in Table 7.1. It can be seen there that the Bahamas has no personal income tax, no estate duty, no corporation profits tax, no foreign source income, no capital gains tax, no tax on corporate capital and no withholding tax on dividends and interest. It also has no double tax treaties with foreign countries. In the context of a tax haven, the existence of double tax treaties appear to have both advantages and disadvantages depending on the domestic tax structure. In a situation where there are no taxes on income or profits accruing to locally registered or incorporated entities, there appears to be little or no need for an instrument designed to obtain credit for foreign taxes paid. If a main purpose of a treaty between two countries is the exchange of information relating to the foreign activities of their respective nationals, such a measure would appear to be even less desirable from the point of view of a tax free jurisdiction intent on attracting tax haven business.[13] On the other hand, for jurisdictions such as the Netherlands Antilles and the British Virgin Islands which impose varying degrees of taxation on income and profits, double tax treaties would seem to be an important part of their administrative structure if they are to sustain any degree of tax haven activities, especially those relating to the incorporation of companies designed to act as vehicles for the receipt of foreign incomes of various sorts which are subject to local taxation. In examining Table 7.1, it should be borne in mind, as indicated earlier, that the absence of taxes by itself is not a sufficient condition for attracting tax haven business. A good example in support of this point is the case of the Turks and Caicos Islands which have attempted to emulate the Bahamas by creating a tax free environment to which, so far, there has been little response, judging from the volume of existing business. A major explanation lies in the relative inaccessibility of these islands, coupled with the lack of professional services and other infrastructural requirements which nearby competitors have already succeeded in developing to an advanced stage. These deficiencies have clearly outweighed its advantage as a British colony — a status which has certainly been a plus point in the emergence of several other countries as tax havens. The Cayman Islands, too, despite a tax free climate guaranteed since the eighteenth century, languished in virtual obscurity until political developments in the Bahamas, in the the latter half of the '60s, drove many Bahamian-based institutions into setting up offices in that country.

A cursory look at Table 7.1 shows that several of the more popular and well known havens are, in fact, dependencies or former possessions of Great Britain. There are a number of reasons for this. Besides the element of stability which the association imparted to the political life of these countries, the existence of the Sterling Area arrangements provided an ideal financial framework for tax avoiders wishing to escape the full brunt of the tax system in the United Kingdom. A factor of more far reaching importance, however, and one which has contributed greatly to the growth in popularity of these centres even after disbandment of the Sterling Area, is the common law tradition which has been inherited from the 'Mother' country. This is of particular significance in the context of trust operations around which an enormous part of tax haven activities is centred, at least in British and former British jurisdictions.

The Trust

The 'trust' is a peculiarly Anglo-Saxon concept, having its origin in thirteenth century England. It was first conceived as a means of evading the law (the Statutes of Mortmain) which sought to prohibit the alienation of land to the Church to which many persons were disposed to bequeath their property.[14] Since then, however, the concept has developed to apply to a wide range of assets (e.g. stock, shares and insurance policies) and now ranks as "one of the more important and flexible institutions of modern

TABLE 7.1
SUMMARY OF TAXES

	PERSONAL INCOME TAX	ESTATE DUTY	CORPORATION PROFITS TAX	TAX ON FOREIGN SOURCE INCOME from patent trade marks etc.	CAPITAL GAINS
STERLING AREA					
CHANNEL ISLANDS	20%	None	20%	20%	None[b]
ISLE OF MAN	20.5%	None	20.5%	20.5%	None[b]
NON STERLING AREA					
BAHAMAS	None	None	None	None	None[b]
BERMUDA	None	None	None	None	None
BRITISH VIRGIN ISLANDS	5% of gross income plus 12% of net income	None	15%	Depends on status of recipient	None
CAYMAN ISLANDS	None	None	None	None	None
HONG KONG	5–15%[c]	5–15%[c]	17%[c]	None	None
LIECHTENSTEIN	up to 20.8% Non-employed residents aliens may pay 15%	0.5–2.7%	7.5–15%[e]	None	None
LUXEMBOURG	Up to 57%	2–48%	40%	12%[e]	Taxed as income or profits[e]
NETHERLAND ANTILLES	Effectively 0.66–46.2%	1–16%	27–34% plus 15% municipal surtax[e]	2.4–3%	Taxed as income or profits[e]
NEW HEBRIDES	None	None	None	None	None[e]
PANAMA	2.5–56%[c]	4.33–75%[c]	10–50%[c]	None	Depends on nature of assets sold
SWITZERLAND	up to 11.5% plus cantonal taxes	Differs according to cantonal laws	Effectively 3.6%–11.5% plus cantonal taxes[e]	Depends on on status of recipient	Differs according to cantonal laws

a; No tax is withheld from payments to non-residents
b. Except in relation to local property deals.
c: Local source income or assets only.
d: Subject to referendum approval.
e: Not applicable to holding or domicilliary companies.

IN THE MAIN TAX HAVENS

ANNUAL TAX ON CORPORATE CAPITAL	WITHHOLDING TAX		TAX & FAVOURED COMPANIES Incorporation tax or duty on authorised capital	Annual tax registration fee	DOUBLE TAX TREATIES
	DIVIDENDS	INTEREST			
None	20%[a]	20%[a]	0.5%	£300	Jersey with Guernsey the U.K., and France Guernsey with Jersey and the U.K.
None	20.5%	20.5% (none on bank interest)	£5–£100 plus £20 for first £2,000 then 0.5%	None	U.K.
None	None	None	0.2% on share capital 0,3% on loan capital	B$260[h] ($1,000)	None
None	None	None	0.25%	Bd$650	None
0.1% ($25–$5,000)	15%	15%	$100	0.1% ($25–$5,000) plus $10	Denmark, Japan, Norway, Sweden, Switzerland, USA.
None	None	None	0.1%(CI$750) min.–CI$1,800	0.5% (CI$375 min.–CI$1,200 max.	None
None	None	15% (on rates over 2.5%	None	HK$300+ HK$4 per HK$1,000 nominal share capital	None
0.2%	4%[e]	4%[ef]	SwFr200 plus Sw Fr50 for each additional Sw Fr100,000; also 2% on paid up capital	0.1% of net worth (Sw Fr 1,000 min.)	Austria[e]
0.5%	15%[e]	5%[e]	1%	0.16% of issued capital	Austria, Belgium, France, Germany, Ireland, Netherlands, U.K., USA[e]
None	None	None	NA.fl-NAfl 1,000	NAf.5–NAfl.500	Denmark, Netherlands, Norway, Surinam, U.K. USA.
None	None	None	£10-£200	£10-£200	None
0.5%[c] (B10,000 max)	10%[c]	None	Graduated from B20 on first B10,000 to B0.10 per B1,000 on capital over B1 million	0.5% B$10,000 max) plus B50	None
0.075 - plus cantonal net worth tax	35%	35%	3%	Differs according to cantonal laws	Austria, Denmark France, Germany, Ireland, Japan, Netherlands, Norway, Pakistan, South Africa, Spain, Sweden Trinidad & Tobago, U.K., USA, Canada, Italy, Malaysia, Portugal, Singapore.[g]

f: Except short term deposits or loans
g: Holding companies with large non-Swiss shareholdings may only claim treaty relief in certain circumstances.
h: Non-Bahamian companies.

Source: Caroline Doggart, *Tax Havens and Their Uses* (London: CIU, *Special Report* No. 61, 1979 Edition).

English law being rivalled in this respect only by the modern limited liability Company".[15]

According to Mowbray, no definition of this entity appears to have been accepted as both comprehensive and exact.[16] Generally, however, the term is used to refer to the "relationship which arises wherever a person called the trustee is compelled in equity to hold property, whether real or personal, and whether by legal or equitable title for the benefit of some persons (of whom he may be one and who are termed *cestuis que trust* or for some object permitted by law, in such a way that the real benefit of the property accrues not to the trustee, but to the beneficiaries or other objects of the trust"[17] Put more simply, it refers to the arrangement or set of arrangements by which one party (the trustee) is entrusted with property by a second party (the creator) to administer on behalf of a third (the beneficiary). The trustee can either be an individual or a company.

As indicated earlier, the trust is a very versatile vehicle that can be used for a wide variety of purposes both by individuals and corporations alike. Some of the more common uses to which it is put can be summarised as follows.[18]

(a) to achieve optimum anonymity;

(b) to achieve the maximum reduction of taxation;

(c) to safeguard moveable assets where a foreign corporation may be threatened by nationalisation or confiscation of assets;

(d) as a private or public medium for investment such as a mutal fund;

(e) to give protection to lenders or to debenture holders;

(f) to set up a pension fund or to provide other types of executive or employee benefits; and

(g) to avoid the need for a will or a part of a will.

So imporant a role have trusts come to play in estate planning that many people tend to divide tax havens into two groups,[19] those that have a trust law and those that do not. Included in the latter category are the non-British areas whose attraction rests heavily on the secret account facility[20] and the private company.[21]

The Trust Law and the Bahamas

Like those of Bermuda and the Cayman Islands, the trust law of the Bahamas is basically similar to the law of England without the 'Thellusson Act'.[22] The local legislation in all these countries permits the accumulation of income for the duration of the trust. They have no equivalent of the 80-year perpetuity period provided by the British Perpetuities and Accumulations Act, 1964, except in the Cayman law where an exempted trust can adopt a period up to 100 years.[23]

Another great advantage which these legislations tend to possess is flexibility. It is "possible for wide provisions to be written into a settlement deed to meet the exact wishes of the settler and to provide whatever powers and discretions he may wish to give to the trustees, subject to the duration of the trust being not longer than the period of a life or lives in being at the time of the creation of the settlement and twenty-one years thereafter".[24]

The U.S. Revenue Act of 1962

From the perspective of non-residents, tax havens can be used in two ways. One is to move over physically, taking all one's assets along. The other, which often is the more practical, is to retain one's usual residence or business structure and utilise such tax haven facilities as are permissible within the existing legal framework, to the extent that a monetary benefit can be derived either in the short or longer term. From the point of view of the person's country of normal residence, there is clearly an adverse repercussion on national revenue implicit in both situations. It is therefore not surprising that the countries most affected have in recent years taken steps to close such loopholes, though it is apparent that such moves have met only with partial success. The United States Revenue Act of 1962, for example, made it compulsory for American citizens residing abroad to pay taxes on earnings in excess of $20,000[25] annually. Even when the individual changes citizenship, according to law he has to wait ten years before his obligation to pay U.S. taxes lapses. With respect to the foreign trust the Act sought to impose a withholding tax of 30 per cent on investment income which met certain specifications. Capital gains (long term or short term) realised by the trust were not made subject to current U.S. taxation. This latter feature, however, plus some of the other advantages (e g. income splitting, tax deferral and tax free accumulations) of foreign trusts that survived the 1962 Revenue Legislation were severely reduced or eliminated in the 1976 Tax Reform Act.[26]

Before 1962 there were virtually no restrictions on the use of tax havens by United States individuals and corporation. "An American living abroad paid no U.S taxes on his foreign income; a number of actors and authors moved to Switzerland and other havens in the 1950s to enjoy that freedom. And, thousands of U.S. corporations established tax-haven companies that were little more than fiscal siphons. Frequently, their sole function was to invoice exports made by their parent companies in the U.S. and to receive foreign dividends and licensing fees. This income was available for foreign investment and, thus, could multiply handsomely".[27] This was possible because the law, as it then existed, permitted the deferral of U.S. taxes on foreign income until a distribution was made.

Since 1962, however, when the Revenue Act[28] was introduced with a view to discouraging such practices, the situation has changed in important respects. The thrust of the legislation was not to eliminate tax deferral altogether, but to limit the use of tax haven devices by Americans and American corporations in setting up tax avoidance techniques. The two concepts that are crucial in determining tax liability under the law are the controlled foreign corporation (CFC) and foreign source earnings. Under the present rules, certain types of foreign income accruing to a CFC is now subject to current U.S. taxation. For purposes of the Act a CFC is defined as a foreign company in which more than 50 per cent of the voting stock is in the hands of U.S persons. (In this context U.S. shareholders are defined as U.S. citizens, resident domestic corporations, partnerships, estates or trusts who have at least a 10 per cent interest in the voting power of all classes of voting stock of the CFC)[29]

The two main categories of income to which attention has been directed are income arising from the insurance and reinsurance of U.S. risks and what has been called 'foreign base company income'. With respect to the former, such income is now subject to current U.S. taxation, except in cases where premiums from U.S. risks do not exceed 5 per cent of total premiums and other consideration. Income derived from the insurance of non-U.S. risks remain outside that ambit of the particular provision. 'Foreign Base Company Income' is divided into three categories: a) Foreign base company sales income; b) foreign base company services income; and c) foreign personal holding company income. With respect to (a) such income is defined as income arising from the purchase and sale of personal property if the property is either purchased from a related person or sold to a related person. The property concerned must, however, be manufactured, produced, grown, or extracted outside the country where the CFC is organised and be sold for use or consumption outside of that country. Income derived from the sale of goods produced in the country where the CFC is located continues to be exempt from current U.S. taxation. The same could be said for income arising from transactions by a CFC with non-related customers regardless of the country of origin of the products involved.

Foreign personal holding company income is income which is passive in character and includes dividends, interest, royalities, annuities, etc. There are however a number of exceptions to the latter. For example, rents and royalities received from an unrelated person and derived from the active conduct of a trade or business is not considered foreign personal holding company income. Dividends, interests and gains from the sale or exchange of stock or securities derived in the conduct of a banking or financing business are also excluded from the definition, as are similar incomes derived from the investments by an insurance company of its unearned premiums or reserves. Another class of income exempted relates to interest received by a banking or financial business firm from a related person also engaged in the banking or financing business if the business of each is predominantly with unrelated persons. Also not included are dividends and interest received from a related corporation which is incorporated under the laws of the same foreign country as the CFC and has a substantial part of its assets used in its trade or business located in that foreign country.

Foreign base company services income arises from the performance of technical managerial or other services performed either for, or on behalf of 'a related person' but only where they are performed in a country outside of that where the base company is organised. An exception is made for services performed in connection with sales of goods produced by the base company itself.[30] Also excluded from the definition of foreign base income is income derived from the use, lease or servicing of ships or aircraft in foreign commerce.[31]

> *Shipping, insurance and finance corporations have an easier time than manufacturers, because they are virtually exempted from the requirement to prove that their foreign subsidiaries have a function other than tax avoidance. They remain more or less in the same happy position that everyone was in before passage of the 1962 Act. Many large corporations, have found ingenious ways of taking advantage of the exemptions. United States Steel is a notable example. It owns two shipping subsidiaries in the Bahamas, Navios Corporation and Navigen Company. Navios is the main company; Navigen handles smaller odd-job kinds of hauling. Both companies share officers and premises in Nassau. Between them, they operate some thirty ships — most of them under the Liberian flag — which move bulk commodities and raw materials for United States Steel and for other customers.*
> *The Bahamas offers other interesting possibilities. Navios, or any other United States controlled company of similar financial standing, could invest in new ships, register them in Liberia and charter them out to the United States parent. The ships would not appear on the parent company's books, and their earnings would be entirely free of tax until repatriated to the United States.*[32]

The tax avoiding techniques discussed in the foregoing paragraphs in the context of the opportunities offered by tax haven situations have been developed mainly by Americans and American corporations. Grundy suggests that one of the main reasons for this stems from the intense competition in the export of capital and know-how in which the Americans have been caught up in the post-war period.[33] Investors from other countries have either been prevented by legal sanction from exploiting these devices, or lack the awareness of the advantages flowing from their use. In the case of the British, there are some restrictions, but uncertainties in the domestic legislation seem to be the more important factor. Still, there are a number of companies which have incorporated the use of tax havens in their international operations. A major example is Tanganyika Concessions

> *which has large mining, timber, and land interests in Africa, Australia and Canada, owns an African rail-*

road, and is the largest single shareholder in Union Miniere, the Belgian mining investment company. Tanganyika Concessions is quoted on the London Stock Exchange, but is incorporated in the Bahamas, where it pays no income taxes. Its shareholders pay taxes on their dividends wherever they live – unless that happens to be a tax haven. But the company's undistributed earnings are not taxed at all.[34]

Some Recent Uses of Tax Havens

The restrictive legislations which have sprung up in the developed countries in an effort to limit the use of tax havens by their multinational corporations (MNCs) have indeed succeeded in curbing some of the traditional tax avoidance techniques developed by these entities. New uses to which the facilities offered by tax-free jurisdictions can be put, however, emerge as fast as the older ones become obsolete or unprofitable. As situations change in response to national regulations and international, political, financial and economic developments, transnational enterprises in every field find themselves in a continuous process of adjustment in order to maintain particular levels of activity. The response is rarely one involving curtailment or withdrawal. In this connection, it becomes desirable to formulate and experiment with ad hoc devices and strategies into which the peculiar conditions are explicitly built. Wooster and Thoman[35], in a recent article, have drawn attention to two techniques which are widely used by transnational corporations (TNCs). One is the 'fronting loan' and the other is the 'international financing subsidiary'. The first device has its origin in the search by TNCs for methods of overcoming political risks and, at the same time, minimising tax liability – important considerations in planning foreign investment activities. The process begins with the setting up of a subsidiary in a tax haven. This company can then be used as a pivot for borrowing funds which would then be deposited in a bank in some major financial centre, say London. Because of its tax-free position, the subsidiary receives tax-free income.

The bank then makes a loan, equivalent to the deposit to an MNC affiliate in a politically unstable or less developed country. Since, in the event of a foreign exchange shortage, the less developed country is more likely to allow the local affiliate to repay a loan to a foreign bank (on whom the Government itself may depend for financing) than it is to allow it to transfer scarce foreign currency to the parent company, this procedure reduces the multinational's financial risk. The entire transaction washes out on the MNC's books.[36]

In the case of the international financing subsidiary, this device can be traced back to the 1960s which witnessed the institution of a series of measures by the United States Government designed to stem the outflow of capital to overseas territories, in a broader effort aimed at correcting a persistent balance of payments problem. Faced with this situation, many U S. corporations made resort to the Euro-dollar market or one of the other major currency markets issuing bonds that could be taken up by non-Americans. In many cases, the parent company sets up a finance subsidiary in a tax haven country (usually the Bahamas, Luxembourg or the Netherlands Antilles) from which it issues its bonds.

> *Euro-dollar bonds do not have taxes withheld on interest paid, so that not only is the effective yield to the lender higher than is true with regular bond issues, but the issue costs to the parent company can be reduced by issuing them in a tax haven. Because the bond issue is more attractive to the lender it may result in a more successful means of raising revenue for the borrower.*[37]

In the past, the borrowing capabilities of such subsidiaries (often backed by guarantees from the parent company) have been used to fund the operations of affiliated concerns in various parts of the world. The convenience, flexibility and economy which this method of financing offers, continue to make it attractive even after the removal of the United States' controls on overseas investment and bank lending.

Fiscal Structure and Implications

In the last few pages, we have focused our attention on some of the advantages to be derived by foreigners and other corporate entities from the use of tax havens. In the following sections, we look at the benefits accruing to the Bahamas from the operation of tax haven conditions and the ways in which the latter are likely to affect economic policy and national decision-making in the context of the development goals which the Government has set itself.

As far as can be discerned, the Bahamas has always been a tax haven, though it is only in the post-war period that its potential for tax avoidance purposes (like that of most other now well-known tax sanctuaries) began to be fully recognised for reasons discussed earlier. While it is not known whether there was any specific incident[38] or factor which was responsible for this group of islands being exempted from the imposition of income taxes by the British Colonial administration, (under whose jurisdiction they were continuously between 1783 and 1973) it seems likely that the reasons why no such taxes were ever introduced were probably due to the structure and organisation of the economy prevailing for most of the country's history, and the consequent difficulties posed for the implementation of a direct taxation system. The result has been that the Government of the country has always had to rely heavily on indirect taxes (import duties in particular), for a substantial proportion of its revenue to carry out its administrative functions and other commitments which have been growing at a particularly fast pace over recent years. Even with the growth of income which has followed the promotion of the Bahamas as a tax haven and tourist resort in the post-war period, sources of Government's income have remained vary narrowly confined. However, a few new taxes have been levied and old ones modified in an effort to equate revenue growth with the unusually large increases in expenditure that have taken place as a result of Government's social and economic undertakings.

The sources of Government's current revenue over the period 1970 to 1978 are set out in Table 7.2. On average, it would appear that over 80 per cent of income over the period came from tax sources, while the other 20 per cent were of a non-tax nature, being derived mainly from fees, service charges, revenue from government property and services of a commercial nature. Though the proportion of funds contributed by import duties to tax income has been falling over the years, this is still the largest single contributor, amounting to an estimated 69 per cent in 1978. (The contribution of export levies is insignificant). As can be seen in the table, more than half of all Government's revenue still comes from the foreign trade sector. Except for certain exemptions (e.g. properties owned by churches, schools, etc.), the real property tax shown is levied on all developed properties in New Providence, regardless of the nationality of owners. In the Family Islands, only developed properties owned by non-Bahamians or non-Bahamian companies[39] are subject to the tax. Before 1977, undeveloped land was excluded from the provisions of the Real Property Tax Act, and this not only affected the base of the tax but, no doubt, also served to encourage speculation. Since then, an attempt (albeit partial)[40] has been made to correct this deficiency. All undeveloped properties owned by non-Bahamian companies (except those which the Minister of Finance is satisfied are being used exclusively for commercial farming), whether located in New Providence or the Family Islands, are now subject to tax. The rate of the tax ranges from half of one per cent to one and a half per cent per annum,[41] depending on the assessed value of the property. Persons who live in their homes for nine months of each year prior to the assessment year are exempted from the tax on the first $20,000 of the assessed value. The Gaming Taxes, though relatively new, are estimated to have contributed 6 per cent to total revenue (7.2 per cent to tax income) in 1978.

In addition to a basic annual tax of $200,000, casinos are required to pay a tax on 'gross winnings' defined as "the sum by which the amount of money or money's worth received by that casino exceeds the amount of money or money's worth paid out by that casino during that period to persons gaming".[42] The figures relating to the Tourism Tax comprise (as footnote c indicates) a departure tax, a passenger ticket tax and a hotel occupancy tax[43] Hotels in New Providence with more than ten rooms (more than twenty-five rooms in the Out Islands) pay an annual licence fee of three dollars per person. In addition, they are also required to pay a tax of seventeen cents per guest-day in the summer season, and twenty-five cents per guest-day during the winter. A large part of these charges is passed on by the

TABLE 7.2

SOURCES OF GOVERNMENT CURRENT REVENUE, 1970–1978

Sources	1970 $'000	1970 %	1972 $'000	1972 %	1974 $'000	1974 %	1976 $'000	1976 %	1978[a] $'000	1978[a] %
Import & Export Duties [b]	54,864	59.9	50,782	49.0	70,990	55.4	74,558	51.9	85,930	51.2
Excise Tax	4,099	4.4	1,873	1.8	3,141	2.4	—	—	—	—
Property Tax	1,095	1.2	1,534	1.5	2,840	2.2	3,839	2.7	6,000	3.6
Motor Vehicle Tax	1,150	1.3	1,429	1.3	2,881	2.2	3,120	2.2	3,690	2.2
Gaming Taxes	6,730	7.3	7,820	7.6	8,898	6.9	9,269	6.4	10,000	6.0
Tourism Tax[c]	3,211	3.5	5,553	5.4	4,956	4.0	5,011	3.5	6,002	3.6
Stamp Tax	3,295	3.6	4,039	3.9	6,474	5.0	7,847	5.5	9,000	5.4
Other Taxes [d]	3,462	3.8	6,703	6.5	6.054	4.7	14,139	9.7	17.957	10.6
Total Tax Revenue [e]	**77,906**	**85.0**	**79,733**	**77.0**	**106,234**	**82.8**	**117,783**	**81.9**	**138,579**	**82.6**
Fees & Service Charges	2,754	3.0	4,980	4.8	5,720	4.4	6,374	4.4	12,503	7.4
Revenue from Govt.										
Property	921	1.0	638	0.6	2,412	1.9	2,629	1.8	5,845	3.5
Interest	499	0.5	55	0.0	458	0.4	1,135	0.8	3,043	1.8
Re-imbursement & Loan Repayments	2,813	3.1	10,574	10.2	5,881	4.6	8,045	5.6	2,071	1.2
Services of a Commercial Nature	6,733	7.4	7,550	7.4	7,548	5.9	7,780	5.5	5,748	3.5
Total Non-Tax Revenue [e]	**13,720**	**15.0**	**23,797**	**23.0**	**22,019**	**17.2**	**25,963**	**18.1**	**29,210**	**17.4**
Total Current Revenue	**91,626**	**100.0**	**103,530**	**100.0**	**128,253**	**100.0**	**143,746**	**100.0**	**167,789**	**100.0**

a Estimate.
b Includes inland taxes on cigarettes, radio, T.V. sets, gasoline and fuel oils.
c Hotel occupancy tax + passenger ticket tax + departure tax.
d For a breakdown see Table 7.3.
e. These figures include refunds in respect of Incentive Acts and other refunds.
Source: Official *Estimates of Revenue and Expenditure*, Ministry of Finance.

hotels to the guests in the form of a toll.

The item 'Other Taxes' is broken down in Table 7.3. Until the end of 1976, all companies registered in the Bahamas paid an annual fee of $250.[44] Since then companies which are not 60 per cent owned and controlled by Bahamians have been required to pay $1,000. Banks and Trusts companies (excluding nominee and inactive entities which pay $450 each) pay fees ranging between $900 and $9,000 per year depending on the type of licence they hold. Exchange control privileges carry additional annual charges of between 22.5 and 45.0 thousand dollars. Insurance operators[45] pay an initial registration fee of between $1,000 and $3,000 depending on the kind of business they write as well as annual renewal fees based on the amount of new business written, the minimum payment in any one year required, however, being set at $500.[46] Since the beginning of 1977 insurance companies have been required to pay one per cent of their gross premiums into the public treasury. The stamp tax payable on property conveyances varies with the value of the transaction.[47] On import entries, the levy is one per cent, while export entries attract on ad valorem rate of half of one per cent. The other items shown in Table 7.3 are more or less self-explanatory, and there is therefore no need for further comment.

Since taxes form an important part of the operations of the modern state, it would be useful at this point to outline briefly, the major reasons for this situation. Then we shall go on to identify some of the features which are considered most desirable in a tax system. The discussion will of course be carried out with reference to the fiscal structure of the Bahamas.

Governments generally, and in a development context in particular, are burdened with the responsibility for providing a wide range of services which are essential to the functioning and growth of the economy and society. Broadly speaking, these relate to areas such as education, health, water and sewerage, power, airport facilities, roads and public transport. Very often some of these services are provided on a commercial or semi-commercial basis and therefore the cost of operation, or at least part of it, is covered by internal income, with government making up for any shortfalls through the provision of budgetary subsidies. Where the services are provided free of cost to the society, the state, in such cases, meets the entire cost of operation. Besides this current aspect of public expenditure, governments are also engaged in extending existing facilities or increasing the range of services, both of which tend, over time, to have expansionary repercussions on current expenditure. The ultimate aim of all such activities of course is to increase income and output over time and it is mainly by recouping a reasonable share of the incomes generated that its ability to meet its expanding obligations can be maintained. Grants and borrowing (both internal and external) can make some contribution to government's efforts in providing certain basic public services, as does the printing of money, but these sources have their limitations, resort has to be made to

TABLE 7.3

CONTRIBUTION OF SELECTED TAXES TO GOVERNMENT'S REVENUE, 1970–1978

Sources	1970 $'000	%	1972 $'000	%	1974 $'000	%	1976 $'000	%	1978[a] $'000	%
Bank and Trust Cos. Fees	484	14.0	1,841	27.4	1,551	25.6	1,386	9.8	1,600	8.9
Insurance Cos. Fees	67	1.9	91	1.4	91	1.5	359	2.5	600	3.3
Companies Fees & Registration	1,436	41.5	2,096	31.2	1,967	32.5	5,557	39.3	5,500	30.6
Business Licences	–	–	–	–	3	0.0	14	0.1	4,000	22.3
Trade and Professional Licenses	68	2.0	117	1.7	92	1.5	187	1.3	–	–
Immigration Fees	1,365	39.4	2,485	37.1	2,090	34.6	6,569	46.5	6,200	34.6
Sundry Taxes	42	1.2	73	1.1	260	4.3	66	0.5	17,957	0.3
Total	**3,462**	**100.0**	**6,703**	**100.0**	**6,054**	**100.0**	**14,138**	**100.0**	**17,057**	**100.0**

a Estimate.

Source. Official *Estimates of Revenue and Expenditure,* Ministry of Finance.

taxes, made for the most part, in the financing of state activities.

As indicated earlier, the function of taxes goes well beyond their immediate objective of raising revenue for the government to carry out its functions. However, these may be defined. In a developing country where the state has to assume a crucial role in stimulating and guiding the development process, taxes have been found particularly useful in this exercise. There are several reasons for this, the most important of which have been extremely well summarised by Mrs. Hicks in her book *Development Finance.*[48] Firstly, it is argued, taxes are the most efficient way of securing the transfer of command over resources to the government. Secondly, in view of the low level of private savings in these countries, which generally reflects the low level of income, which in turn can be attributed to low rates of capital formation, it is necessary for government to supplement private savings with public savings if the circle of proverty is to be broken. A third objective which taxation seeks to achieve is a redistribution of income between rich and poor, without at the same time destroying the incentive for greater production and income, though these objectives are often difficult to reconcile. A further goal is the encouragement of certain types of activities through manipulation of the tax system, though in practice this in itself may have very little real effect on private enterprise. A final area in which the tax system can be employed is in reducing inflationary pressures in times of excess demand or in stimulating the economy in periods of slack. While this latter technique is often of little relevance in developing countries with their narrow production base in relation to total supply, the former not only provides government with a proportion of the increasing income generated by its activities, but can also at the same time serve to mitigate the effects on the country's balance of payments by absorbing some of the import demand generated by inflationary pressures.

As can be seen then, taxation can be used for a wide variety of purposes closely connected with the problems which governments in poor countries encounter in the process of mobilising resources with developmental objectives in mind. From the perspective of the above discussion, however, the role and effectiveness of the public sector tend to be influenced by two factors: one is the structure of the tax system, and the other is the level of revenue (and expenditure) in relation to national income. Having already, in an earlier section, touched upon the respective contributions of major taxes to the Bahamas' Government revenue, it will, therefore, serve no purpose repeating that discussion at this point. It is, however, worth drawing some attention to defects of the system in the light of the arguments in the last few paragraphs.

The first point that should be noted about the Bahamas tax system is that it is not the result of a carefully thought-out scheme formulated from a long term perspective or within an articulated development strategy. As indicated earlier, the structure has evolved largely as an ad hoc[49] one designed to meet revenue needs and paying little attention to other considerations.

Initially, corporate and personal income taxes were ruled out because of their irrelevance or impracticability within the economic and organisational structure of the economy, and heavy reliance therefore had to be placed on the foreign trade sector which, because of its size, the high degree of monetisation and administrative convenience has always been an easy target for taxation.

The decision in the years immediately following the end of the Second World War by the local administration to promote the Bahamas as a tourist resort cum tax haven and the subsequent success of this policy removed, even further, the possibility of income and corporate taxes being introduced, even though the circumstances for their implementation have grown increasingly better with the increases in income and the growth in the number of companies and wage and salary earners. With the natural expansion in government expenditure dictated by the effects of population growth on social investments, and maintenance of public infrastructure, and given the limits on trade taxes, the Government has had to turn increasingly to other sources which are shown in Table 7.2. Even in these directions, however, it cannot press too hard for fear of becoming uncompetitive in a world with an increasing number of tax havens, or making unprofitable the casino activities and the hotel business.

It is beyond the scope of this study to go into a detailed discussion of the advantages and disadvantages of the various kinds of taxes or the problems of concepts and definitions which arise when one seeks to categorise them, or assess their economic effects. There is need, however, in light of earlier analysis to make some general remarks on the nature of the Bahamas tax system and the way it is likely to affect Government's policy.

Earlier on, it was established that import taxes alone normally contribute over 60 per cent to the Bahamas Government's total tax takings. This proportion is of an extremely high order, particularly when it is remembered that in many developed countries the figure is less than 10 per cent. While there are strong arguments in favour of trade taxes such as the ease of valuation and collection, a major disadvantage (which also applies to a whole range of other commonly used indirect[50] taxes) is their regressive nature i.e. all persons tend to pay the same amount of tax, regardless of income size. In effect this means that the poorer sections of the community are required to surrender to government a higher proportion of their earnings than the richer strata who are in a better position to pay. In a situation where income is fairly well distributed, there is no reason for any great concern from a social point of view. In societies, however, where a large proportion of the population receives a relatively small part of total income, equity demands the discriminate use in the imposition of such taxes, and in this connection Governments normally try to introduce an element of progressivity by exempting completely or taxing at very low rates essential items, while subjecting luxury and semi-luxury products to higher rates.

The level and extent of exemption will depend on the degree of reliance on import duties as a source of government revenue as opposed to other sources. The upper limit to rates will be influenced by the necessity that imports should not be choked off altogether, in which event the amount of revenue collected will be affected. From the above, it is clear that there are real limits on the extent to which government can draw on import taxes to finance its various activities. An even further difficulty arises when there is a drop in the volume of taxed imports for any reason, or if in the interest of the balance of payments, governments has to deliberately curtail goods from abroad, which clearly would be the luxury or high taxed items which contribute most to the public income. A high dependence on import duties, therefore, would seem to place severe constraints on government's ability to deal with problems arising from the external sector or in planning the budget. At the same time, as indicated earlier, the absence of income taxes puts the authorities at a severe disadvantage in dealing with internal demand/supply disequilibrium situations. In the context of the Bahamas, it should be noted, while internal taxes may be useful in reducing excess demand pressures with the aim of saving foreign exchange, attempts to stimulate the economy by increasing the purchasing power of the public will only result in higher imports and balance of payments problems, given the heavy dependence of the economy on external sources of supply.

Tax Performance

There was a time when the function of government was seen as extending little beyond the preservation of law and order, and the provision of security. In the post-war years, however, this limited concept of the role of the state has undergone a radical change and now includes such broad objectives as the promotion of economic growth and development, and explicit commitments to public welfare and social justice. Concomitant with this expansion in perspective has been an increased need for revenue to carry out the various functions expected of it. In the Bahamas, the present Government which has been in power since 1967, has not only found itself facing rapidly increasing social expenditures as a result of its efforts to compensate for the long period of neglect shown by the previous administration in this area, but has incurred greater commitments by decisions relating to the creation of a broad range of institutions and the attainment of political independence which has brought in its train greater responsibilities and obligations. Growing public sector employment and the increased cost of public administration have also added to the burden of the government finances. Since in a developing context the level of revenue tends to be more often determined by the level of government expenditure, rather than the other way around, the relatively inelastic tax base faced by the authorities has not surprisingly led to a rapidly increasing public debt position in Government's attempt to carry out its social welfare programmes and increase the efficiency and productive capacity of the economy.

Real development inevitably involves an increase in public expenditure, mostly in non-revenue yielding projects, and for this reason, it is essential that the tax system be so structured that as income rises an increasing proportion will accrue to the public purse. 'That is to say, incremental tax incidence must be higher than average tax incidence'.[51] In this connection, the personal income tax formulated on the basis of the progressive principle has often been suggested as an ideal instrument. In the Bahamas, successive governments have repeatedly pledged themselves, as a matter of policy, against the introduction of such taxes and have, therefore, had to look increasingly to other sources for funds to meet rising expenditure, some of which have already probably yielded as much as they can in the existing circumstances.

In looking at the level of government revenue, therefore, one has to view this more as a reflection of policy, rather than as an index of the country's effort which might be meaningfully compared to that of other countries in similar economic circumstances. Having said this, however, it should be interesting to see how the Bahamas' performance within the peculiar framework we have described, compared with that of a number of other countries which impose a wide variety of taxes to finance their development effort and sustain current expenses.

The amount of tax collected by various governments depends on a wide range of factors. The most general of these, is, of course, the political philosophy of the government, itself, which determines the extent of its involvement in the economy, and the scope of its role in the provision of public services. Other factors might include the extent to which vital services such as those relating to health and education are provided by private or non-profit organisations concerned with the welfare of the society. From this it is clear that the amount of tax collected by a government may bear no relation to taxable capacity, and one, therefore, has to be careful in making comparisons between countries on the basis of such yardsticks as the ratio of tax to national income and drawing welfare conclusions from such an exercise.

In Table 7.4, we present the proportion of tax collected to Gross Domestic Product[52](at market prices) for a number of countries both in the developed and developing world, and relate these ratios to per capita income which is often used as an index of taxable capacity. The respective shares of income tax and import duties in total tax are also given with a view to elucidating certain points made earlier on the pattern of revenue in advanced and developing countries. As can be seen, the proportion of tax revenue to GDP[53] for the countries shown ranges over a very wide area from as low as 4.8 per cent for Haiti to 25.9 per cent for the U.K.[54] Since the end of the Second World War, there has been a growing controversy as to what constitutes a safe limit to taxation. Some years ago, drawing on the experience of a number of countries, Colin Clarke[55] put forward a figure of approximately 25 per cent of national income[56] arguing that anything in excess of this proportion will always bring about inflation. While many commentators

TABLE 7.4

SELECTED CENTRAL GOVERNMENT TAX DATA FOR SELECTED COUNTRIES, 1976

Countries	Per Capita GNP[a] 1976 US $	Tax Revenue[b] as a % of GDP[a] 1976	Income Taxes as a % of Tax Revenue 1976	Import Duties as a % of Total Tax Revenue 1976	Indirect Taxes as % of Total Tax Revenue 1976
Switzerland	9,160	7.9	35.6	26.3	64.4
Canada	7,930	15.0	69.0	6.9	29.1
United States	7,880	15.0	86.8	2.1	10.6
West Germany[c]	7,510	23.2	54.8	n.a.	45.1
United Kingdom	4,180	25.9	59.0	15.3	38.2
Singapore	2,580	16.0	51.4	10.1	18.0
Trinidad & Tobago[d]	1,950	25.3	84.4	6.9	15.5
Barbados	1,620	18.3	53.0	30.4	46.9
Panama	1,170	10.2	47.3	21.8	52.5
Jamaica	1,150	17.1	43.9	18.8	47.1
Costa Rica	1,130	13.0	22.8	14.7	77.0
Mauritius	680	22.5	47.2	21.7	45.7
Guyana	570	27.5	59.2	14.6	40.8
Liberia[e]	410	18.8	53.9[f]	n.a.	46.0
Haiti	220	4.8	16.4	42.3	83.6
Tanzania	180	14.8	31.3	13.2	58.0
India	140	7.8	24.4	n.a.	75.0
Malawi	130	10.6	46.6	22.5	53.0

Note: Because of the highly aggregative nature of the data used, the proportions presented in this Table are to be regarded as very rough estimates:

a: At current market prices.

b: Generally excludes social insurance taxes and contributions.

c: Combined Federal and Laender

d: 1975 figures.

e: Tax figures used exclude maritime revenues.

f: Reflect the position of all direct taxes.

Sources: U.N. *Statistical Yearbook,* 1977; IMF, *Financial Statistics,* August 1979; World Bank *Atlas,* 1978.

agree that there is an absolute limit to taxation in the form of the size of a country's income and its national wealth, the vast number are of the opinion that there can be no optimum level applicable to all countries or to the same country at different times. The concept of taxable capacity, it is argued, not only has to be viewed in a dynamic sense but has to be defined in the light of a wide range of economic, political, cultural, psychological and institutional factors which vary from country to country. In this connection, the limits of tax capacity tend to be a function of such diverse factors as national product, per capita income, the distribution of income, occupational distribution of the working population, tax rates, administration, voluntary compliance habits, accounting and assessment procedures, the overall tax structure, human attributes and motivations and, not least of all, the purpose of governmental expenditure.[57]

While recognising this situation, economists, nevertheless, still try to compare actual tax performance with potential revenue effort over a period of time in context of such variables like national income, per capita income and the size of the foreign trade sector. Because of the absence of an income or corporation tax in the Bahamas, one would expect a fairly low correlation between income variables and the growth of tax revenue. Dependence on import duties and other taxes on goods and services gives a more crucial role to these measures in the overall tax effort. Bearing in mind that some of the data available are of a very tentative nature, an attempt is made to offer some broad comments in the following paragraphs on the revenue situation prevailing in recent years and the pattern of expenditure which has emerged within the framework of Government's policy and the existing financial constraints.

In Table 7.5, we present some selected data relating to Government finances over the 1969-77 period.[58] It would appear from this table that total revenues collected in recent years have amounted to between 14 and 19 per cent of GDP, while income from tax sources only, seemed to have hovered around 13—16 per cent.[59] The limited figures available do not indicate any clear trend, and in this connection it is worth pointing out that the ratios involving the GDP have obviously been influenced by the slow growth of the latter in the period covered in the table. Though the tax/GDP ratio for the Bahamas appear to compare favourably with several countries shown in Table 7.4, there are certain factors which should be borne in mind. One is the extremely tentative nature of the Bahamas GDP estimates. Another, which is of particular relevance where the less developed countries are concerned, relates to the fact that while these states may have income and profit taxes, the generally low per capita income prevailing, and the problem of valuation and collection arising from non-market production, make for very low yields on these taxes.

It has often been argued (and quite justifiably) that one indicator of the degree of equity in a tax system is the extent to which the share of incomes taxes in total tax revenue rises as the economy develops. What

TABLE 7.5
SELECTED GOVERNMENT FINANCES, 1969 TO 1977

$m.

Items	1969	1971	1973	1975	1977	Average % Growth Rate of Revenue, Exp. & GDP Over the 1969-77 Period	Rev. & Exp. Elasticities [c] 1969-77
1. Current Revenue[a]	74.6	77.5	108.8	120.7	139.7	8.1	1.3795
(Tax Revenue)[a]	(67.2)	(68.6)	(96.2)	(98.2)	(124.7)	(8.1)	(1.3526)
2. Current Expenditure	61.8	79.6	93.5	114.0	136.0	10.4	1.898
3. = (1) – (2)	+12.8	–2.1	+15.3	+6.7	+3.7	–	–
4. Capital Expenditure	16.6	12.5	13.5	13.8	23.7	4.5	0.6762
5. = (2) + (4)	78.4	92.1	107.0	127.8	159.7	9.1	1.6394
6. = (1) – (5)	–3.8	–14.6	+1.8	–7.1	–20.0	–	–
7. GDP (at market prices)	487.7	520.6	595.0	691.6	796.2	–	–
8 = (1) as a % of (7)	15.3	14.9	18.3	17.4	17.5	–	–
9 = (5) as a % of (7)	16.1	17.7	18.1	18.5	20.1	–	–
10. Tax Revenue as a % of GDP	13.8	13.2	15.7	14.2	15.7	–	–
11 Indirect Taxes[b] as a % of Total Tax Revenue	86.0	80.4	70.0	68.3	67.6	–	–

a: These figures exclude refunds in respect of incentive Acts and other refunds and therefore are not comparable with the equivalent series in Table 7.4.

b: Defined here to include only Customs Duties (including Emergency and Inland Taxes) and Excise.

c: Rev. Elast. = $\frac{\Delta \text{ Rev.}}{\Delta \text{ GDP}} \times \frac{\text{GDP}}{\text{Rev.}}$

Exp. Elast = $\frac{\Delta \text{ Exp.}}{\Delta \text{ GDP}} \times \frac{\text{GDP}}{\text{EXP.}}$

Sources: Central Bank of the Bahamas, Quarterly *Review*, various issues; Table 1.4.

this in fact means under a progressive structure, is that the incidence falls on those who are better able to pay as measured by the growth in incomes. As stated earlier, there are no income or profit taxes in the Bahamas which considerably weakens the fiscal system in the context of mobilising resources, redistributing income and controlling demand conditions. Government still relies on indirect taxes for some 70 to 80 per cent of its tax revenue (See Table 7.2), and though it appears that the proportion is declining, this trend is unlikely to continue for too long, given the limits on the complementary tax sources. The tax pattern, we have pointed out, is a regressive one though the degree of regressivity is to some extent reduced by the structure of the rates, which generally are higher on luxury and semi-luxury items than on food and medicinal products, some of which are exempt from import taxes.

When we look at the expenditure side of Government's account for the 1969-78 period, we observe that although the current component appeared to have grown at a slightly higher average rate in nominal terms than its counterpart on the revenue side, there was a saving in four out of the five years shown. With the exception of 1973, however, this was not sufficient to finance capital expenditure commitments in any of the years, and increasing resort had to be made to borrowing both from internal and to a lesser extent external sources. (Table 7.8 shows the growth of the public debt since 1965). The serious implication of this situation is that unless Government's expenditure follows a pattern that could increase public revenues in the future, (or the tax system is given a more elastic base),[60] the authorities are likely to find themselves in a very difficult position in terms of servicing the national debt. This debt could in time become a very heavy burden impinging on other priority areas, thus putting the government under even more severe financial pressure. In Tables 7.6 and 7.7 we present a breakdown of Government's spending by major functions. As can be seen, 'General Public Service' alone takes over 20 per cent of the budget, while social services (3—7) takes more than 40 per cent. The latter increased its share from 41.4 per cent in 1969 to an estimated 48.6 per cent in 1978, education accounting for a large part of the increase. The share of economic services in current expenditure seems to be falling, decreasing from 27.2 per cent in 1969 to 16.7 per cent in 1978. More than 50 per cent of the capital budget, however, is generally spent in this sector which with education absorbs more than 80 per cent of the annual capital expenditure. As can be seen from the tables, the largest component is 'Public Works and Water Supply' whose share over the period has fluctuated between 32 and 50 per cent.

It is clear, then, from the analysis above, that the thrust of government spending (which is aimed primarily at providing social services and building up the infra-structure of the country), is such that Government cannot expect to recoup any significant part of its expenditure in the near future, or one might argue even in the distant future, since it does not have the necessary instruments which would enable it to appropriate, in a fairly

TABLE 7.6
FUNCTIONAL CLASSIFICATION OF GOVERNMENT EXPENDITURE, 1969 TO 1978

$m.	1969		1971		1973		1975				1978[a]	
Category	Current	Capital	Current	Capital	Current	Capital	Current	Capital	Current	Capital	Current	Capital
1. General Public Service	15.2	0.8	18.4	0.4	22.7	0.4	27.6	0.2	33.2	0.2	36.5	0.2
of which (General Administration)	(8.6)	(0.0)	(9.9)	(0.0)	(13.0)	(–)	(15.2)	(–)	(18.2)	(–)	(19.9)	(–)
(Public Order & Safety)	(6.6)	(0.8)	(8.5)	(0.4)	(9.7)	(0.5)	(12.4)	(0.2)	(14.9)	(0.2)	(16.6)	(0.2)
2. Defence	–	–	–	–	–	–	–	–	0.2	7.7	1.5	3.3
3. Education	13.5	1.9	19.9	3.0	23.7	5.6	29.9	2.6	38.5	1.6	43.5	1.7
4. Health	9.0	0.2	11.7	0.3	15.1	0.2	17.7	0.2	22.4	1.9	26.2	1.3
5. Social Benefits and Services	3.0	–	3.6	–	4.3	–	4.4	–	4.8	–	5.9	–
6. Housing	0.1	0.3	0.1	0.1	0.1	0.0	0.1	0.1	0.1	0.0	0.2	0.1
7. Other Community & Social Services	0.2	–	0.2	–	0.0	0.0	0.3	–	0.8	–	1.0	0.1
8. Economic Services	16.8	13.2	19.4	8.4	20.6	7.2	24.0	10.6	22.8	12.3	26.2	21.6
of which (Agriculture & Forestry)	(0.5)	(0.1)	(1.8)	(0.4)	(0.7)	(0.4)	(1.1)	(0.5)	(2.0)	(1.0)	(2.5)	(1.2)
(Tourism)	(6.7)	(–)	(6.9)	(–)	(8.1)	(–)	(8.7)	(–)	(10.7)	(0.1)	(12.7)	(0.1)
(Public Works & Water Supply)	(8.4)	(6.8)	(8.0)	(6.1)	(8.7)	(4.5)	(10.0)	(4.4)	(5.4)	(5.6)	(6.2)	(2.9)
Transportation)	(0.5)	(4.6)	(1.8)	(1.2)	(1.8)	(2.1)	(2.0)	(5.5)	(2.3)	(5.2)	(2.4)	(5.1)
9. Other of which (Public Debt - Interest)	(3.8)	(–)	(5.8)	(–)	(5.7)	(–)	(10.0)	(–)	(13.0)	(–)	(16.2)	(–)
Total	**61.8**	**16.6**	**79.6**	**12.5**	**93.5**	**13.5**	**114.0**	**13.8**	**136.0**	**23.7**	**157.4**	**28.3**

a. Provisional.

Note: Details may not add to total due to rounding.

Source: Central Bank of the Bahamas, *Quarterly Review,* various issues.

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TABLE 7.7
PERCENTAGE DISTRIBUTION OF GOVERNMENT EXPENDITURE BY MAJOR FUNCTIONS, 1969 TO 1978

Category	1969		1971		1973		1975		1977		1978	
	Current	Capital	Current	Capital	Current	Capital	Current	Capital	Current	Capital		
1. General Public Service	24.6	4.8	23.1	3.2	24.3	3.6	24.2	1.4	24.4	0.8	23.2	0.7
of which (General Administration)	(13.9)	(0.0)	(12.4)	(0.0)	(13.9)	(–)	(13.3)	(–)	(13.4)	(–)	(12.6)	(–)
(Public Order & Safety)	(10.7)	(4.8)	(10.7)	(3.2)	(10.4)	(3.6)	(10.9)	(1.4)	(10.9)	(0.8)	(10.5)	(0.7)
2. Defence	–	–	–	–	–	–	–	–	0.1	32.5	1.0	11.7
3. Education	21.4	11.4	25.0	24.2	25.4	40.9	26.2	18.8	28.3	6.7	27.6	6.0
4. Health	14.6	1.2	14.7	2.4	16.2	1.5	15.5	1.4	16.5	8.0	16.6	4.6
5. Social Benefits and Services	4.9	–	4.5	–	4.6	–	3.8	–	3.5	–	3.7	–
6. Housing	0.2	1.8	0.1	0.8	0.1	0.0	0.0	0.7	0.0	0.0	0.1	0.3
7. Other Community & Social Services	0.3	–	0.2	–	0.0	0.0	0.3	–	0.6	–	0.6	0.3
8. Economic Services	27.2	79.0	24.5	67.7	22.0	52.5	21.1	76.9	16.8	51.9	16.7	76.3
of which (Agriculture & Forestry)	(0.8)	(0.6)	(2.3)	(3.2)	(0.7)	(2.9)	(0.9)	(3.6)	(1.5)	(4.2)	(1.6)	(4.2)
(Transportation)	(0.8)	(27.7)	(2.2)	(9.7)	(1.9)	(15.3)	(7.6)	(–)	(7.9)	(0.4)	(8.1)	(0.3)
(Tourism)	(10.8)	(–)	(8.7)	(–)	(8.7)	(–)	(8.8)	(31.9)	(3.9)	(23.6)	(3.9)	(10.2)
(Public Works & Water Supply)	(13.6)	(41.0)	(10.0)	(49.2)	(9.3)	(32.8)	(1.7)	(39.8)	(1.7)	(21.9)	(1.5)	(18.0)
9. Other of which (Public Debt - Interest)	(6.1)	(–)	(7.3)	(–)	(6.1)	(–)	(8.8)	(–)	(9.5)	(–)	(10.3)	(–)
Total	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Note: Details may not add to total due to rounding.

Source: Table 7.8.

equitable manner, part of the earnings of those who have benefited directly and indirectly from Government's development programmes.

The National Debt

Regardless of the ideological position embraced, governments in developing countries in the post-war period have had to play a leading role in efforts designed to increase social and economic welfare. A significant constraint in this regard has been the insufficiency of national savings in relation to the desirable rate of economic growth. This situation has led to an increasing public debt position in most instances, as governments have sought to raise funds from both internal and external sources to finance the gap between actual savings and desired investment. With regard to the Bahamas a glance at Table 7.8 shows that the Bahamian dollar denominated debt (excluding contingent liabilities) increased (in nominal terms) from less than $10 million at the end of 1965 to more than $140 million at the end of 1978. Over the same period the debt repayable in foreign currency increased from about $8 million to $60 million.

There has been a great deal of discussion in the literature as to what constitutes a desirable level of public borrowing in terms of the 'burden' of the debt, ability to repay and so forth. There is, of course, no magic figure that could be applied to all countries, or even to all situations for any given nation. While there tends to be important differences between the local and foreign components of the public debt,[61] the tax structure is equally important to both from the point of view of repayments. The latter, of course, poses a special difficulty in terms of servicing which requires the availability of foreign exchange. As indicated, while it is often difficult to say what constitutes an optimum level of public borrowing, there are certain broad measures which are often used to give an indication of a possible liquidity problem arising from too great a resort to this medium. One of these is the proportion of debt service to public revenue. In the case of the Bahamas, there has been a steady increase in this ratio in recent years. The figure moved from about 9 per cent in 1972 to 15 per cent in 1976 and to an estimated ratio of 18 per cent in 1978.

What is considered a tolerable ratio would tend to be influenced by a number of factors. One is the extent to which a government can meet shortfalls in revenue by borrowing from the central bank or by printing money. Another is the openness of the economy in terms of the level of imports to national income. The greater the dependence on foreign supplies the greater would be the pressure on the foreign exchange reserves as a result of the expansion in the money supply. This would be particularly the case where the domestic production structure is unable to respond to stimulation from increases in the quantity of money, at least in the short run.[62]

As pointed out earlier, government's revenue position is an important variable in considering the level and growth of both the internal debt and

TABLE 7.8

GROWTH OF THE NATIONAL DEBT, 1965 TO 1978
(End of Year Position)

$m.

	1965	1978	1970	1972	1974	1976	1978[a]
DIRECT CHARGE							
External	—	—	—	—	10.7	7.7	12.3
Other	7.7	24.3	22.3	22.8	25.7	18.7	16.4
Total External	**7.7**	**24.3**	**22.3**	**22.8**	**36.4**	**26.4**	**28.7**
Internal							
(a) **Foreign Currency**	**n.a.**	**6.4**	**5.0**	**6.4**	**31.5**	**30.0**	**30.9**
Government Securities	n.a.	0.4	—	—	6.4	4.6	4.0
Loan Funds	n.a.	6.0	5.0	6.4	25.1	25.4	26.9
(b) **Bahamian Dollars**	**n.a.**	**15.0**	**34.8**	**32.4**	**40.3**	**93.4**	**142.6**
Due to Central Bank	3.0	8.0	8.0	8.0	9.7	18.7	14.9
Treasury Bills	1.4	4.8	7.2	9.7	4.9	10.2	14.0
Other Government Securities	—	—	—	—	23.6	57.6	112.6
Local Loans	3.1	2.2	19.6	14.7	2.1	6.9	1.1
Total Internal	**7.5**	**21.4**	**39.8**	**38.8**	**71.8**	**123.4**	**173.5**
Total Foreign Currency Debt	n.a.	30.7	27.3	29.2	67.9	56.4	59.6
TOTAL DIRECT CHARGE	**15.2**	**45.7**	**62.1**	**61.6**	**108.2**	**149.8**	**202.2**
Contingent Liabilities	9.8	21.5	21.7	29.5	32.8	22.7	30.7
Total National Debt	25.0	67.2	83.8	91.1	141.0	172.5	232.9

a: Provisional.

Source: Central Bank of the Bahamas, *Quarterly Review,* various issues.

the foreign currency denominated debt. Where the latter is concerned, a common yardstick used for measuring external debt-servicing capacity is the debt service ratio (DSR). This is defined as external debt service charges (amortisation and interest) expressed as a percentage of exports of goods and non-factor services[63] in any given year. The 'DSR' varies widely from country to country. In 1977, for example, the ratios for selected countries were as follows:[64]

1.	Barbados	3.3	9.	Mauritania	22.6
2.	Ghana	3.7	10.	Mexico	48.1
3	Guinea	43.5	11.	Nigeria	0.8
4.	Guyana	15.5	12.	Sri Lanka	14.6
5.	India	10.5	13.	Tanzania	7.1
6.	Jamaica	14.9	14.	Trinidad and Tobago	0.5
7.	Jordan	3.2	15.	Venezuela	7.5
8.	Mali	4.0			

The comparable ratio for the Bahamas was estimated to be less than 2 per cent, if the gross earnings from the tourist industry are included in the denominator. The latter, as pointed out earlier, has an extremely high foreign exchange leakage, and this has to be borne in mind in examining the Bahamas foreign debt position. Viewed against the net addition to official foreign exchange reserves in 1977, external debt service payment amounted to over 24 per cent in that year.

It should be stated straightaway that here, too, there is no single ratio that one could apply to all countries in analysing debt positions. The capacity to service debt varies from country to country. A figure that appears low for one state may be too high for another since countries differ in terms of structure of production, foreign assets, etc. In this connection, it should be pointed out that published DSR ratios do not necessarily reflect the various countries level of dependence on foreign resources. A low ratio stemming from a small external liabilities position may be the result of an inability to borrow externally rather than of a condition requiring little or no resort to foreign funds. A low DSR ratio may also reflect defaults (i.e an inability to service debt) rather than a low foreign debt position.

While the DRS itself, as an indicator of the capacity to service debt, may have some limited use in the short run, serious criticisms have been levelled against it as a long term measure. Perhaps, the most important of these criticisms relates to the static nature of the concept. One observer argues that "it does not adequately take into account the rate of growth of foreign exchange earnings and savings which are, in turn, functions of real rates of economic growth in the export and import substituting sectors".[65] It has been suggested that there might be three reasons for its continued use despite this shortcoming. One is the simplicity with which it can be calculated; the second is that the data on which it is derived tend to be readily available and the third is the failure of critics to come up with alternative measures of a more comprehensive nature.[66]

Recognition of the inadequacy of the DSR in assessing the level of a country's foreign indebtedness has led some writers to take a more general approach to the question. One, for example, argues that a reasonable level of foreign borrowing should "depend upon a country's ability to earn and save foreign exchange over and above the immediate requirements for consumption".[67] In the final analysis, this ability would depend on the effectiveness with which borrowed funds are used in expanding productive capacity, both in terms of increasing export potential and reducing the dependence on imports.

Towards A Policy Framework

The ascension to power by the Progressive Liberal Party (PLP) headed by Lynden Pindling in 1967, and the subsequent decision to seek political independence from Britain, give rise to a great deal of speculation concerning the continuation of the policy framework which had guided the growth of the economy in previous years. To clear the air, the PLP Government, in its White Paper[68] on independence, took the opportunity to reaffirm its intention of maintaing the tax haven status of the country, and to declare that "nationalization shall not be an instrument of the Government's economic policy". In the same document it is stated that the "Government is convinced that Independence for the Commonwealth of the Bahama Islands must be based on the economic independence of the Bahamian people. To achieve this end, the Government based its policy on:—

(a) an effective level of control over the national economic environment;

(b) the maximization of the benefits to the Bahamas arising from both domestic and foreign investment; and

(c) an increase in Bahamian ownership and/or participation in business activity where this is feasible.[69]

Granted that the White Paper was a general document which could not spell out the specific instruments by which the government hoped to achieve these aims, it is interesting that it should speak of keeping the tax haven status and of achieving a level of economic control at the same time. In the minds of many people, a tax haven environment and a completely laissez-faire attitude are completely inseparable, and it is this perspective that has bred the speculation and confusion that has prevailed in the post-1967 period both in and outside the Bahamas.

In an earlier section it was indicated that there are some countries that operate a two tier tax system (one applicable to income derived from activities within the country, and another which involves no taxes[70] to entities engaged in offshore business) — a quite reasonable approach that has not affected the image of these countries as tax havens. If anything, the element of certainty in the tax situation has done much to enhance their reputation as 'safe' repositories or bases from which to conduct offshore business. There is absolutely no reason why the Bahamas should not delineate local activities from foreign operations in its attempt to mobilise resources to accelerate the rate of economic progress, and at the same time attain a more secure future for its citizens, without losing its tax haven advantages.

In this connection, there is another important point worth making, and this relates to the urgency of the development problem which is by no means unrelated to the future of the Bahamas as a tax haven. As indicated earlier, an important plank in this status if it is to have any meaning, is a stable social and political climate which can, by no means, be maintained if the masses of the Bahamian people are unable to share in the country's prosperity and economic well being. One way or the other, therefore, Government is constrained to pursue policies not only aimed at maximising income and employment, but more importantly, these have to be pursued within a strategy that can lay the groundwork for a system in which the average Bahamian can earn a reasonable standard of living in a secure and dignified environment.

In an earlier chapter attention was drawn to the large part played by tourism in the economy of the country and some of the existing weaknesses in this sector. It was indicated that this activity does not significantly depend on tax haven facilities, and, in fact, its competitiveness may be affected by the existing tax structure to the extent of the latter's adverse influence on the cost of living. Against these assertions it is necessary to juxtapose certain facts relating to the financial sector in order to provide what might be called an integrated perspective of the system, and to show the relative position of the strategic components.

Earlier reference was made to the insignificance of the contributions made to Government revenue in the form of fees, stamp duties, licences, etc. and there is, therefore, no need to repeat that discussion at this point. A second area in which the financial sector contributes to the economy is in the provision of jobs. According to the 1970 census, financial operations relating both to internal and external activities provided employment for 5,331[71] persons or 7.6 per cent of potentially economically active population which was estimated to be over 70,000. Tourism directly and indirectly is believed to generate about 60 per cent of employment opportunities. In terms of contribution to GNP, it has been estimated that while the latter activity is responsible for about 70 per cent, finance, insurance, real estate and business services put together, contribute (according to estimates for 1970) only about 13 per cent. While figures for more recent years are not available, it is unlikely that the relative positions have changed significantly. The category used above includes, it should be noted, both financial and non-financial activities. Contributions of both onshore and offshore operations (a distinction which admittedly would be difficult to obtain in sharp terms) are also taken together.

In order to assess the contribution being made by financial institutions (banks and/or trust companies) to the economy, the Bahamas Central Bank has started an annual survey to which the response has apparently been quite good. The results for recent years, (which incidentally represent responses from over 80 per cent of the licensed banks and/or trust companies) are presented in Table 7.9. In 1977, the sector employed 2,184 persons of which 1,929 (88 per cent) were Bahamians. The proportion in 1973 was 86 per cent. Total expenditure increased from $33.7 million (5.7 per cent of GDP at market prices) in the latter year to $55.2 million (6.9 per cent of GDP at market prices) in 1977. The items which take the largest shares are 'salaries' (48 per cent in 1977) and 'administrative and miscellaneous expenses' (42 per cent in 1977). The latter is not broken down and, therefore, it is not possible to say what the contributory components are.

Financial institutions like other business enterprises employ personnel and incur expenses wherever they are located. No special claim can, therefore, be made for these functions, though it should be recognised that the existence of the tax haven and other offshore business does give rise to a larger volume of employment and greater expenditure (wages, salaries, utility payments, etc.) than would normally be the case. While, as indicated earlier, it is difficult to get a strict separation between 'onshore' and 'offshore' operations (some institutions use the same infrastructure to engage in both), it would have been interesting to get contributions to the respective economic aggregates, based on a division of financial institutions into the following categories (a) those that have only a bookkeeping or nominal presence (the 'shell' banks); (b) those that have a physical presence but operate strictly offshore; and (c) the authorised dealers and agents who engage in both local and foreign business.

In discussing the costs of operating an offshore financial centre reference is often made to public expenditure on such things as telecommunications, educational facilities, supervision and regulation etc. It would be misleading, however, to view all budgetary allocations to these areas on a measure of immediate monetary costs since other sectors of the economy benefit from the services provided. The decision to operate an offshore financial centre has other effects, some of which do not easily lend themselves to quantification but which, nevertheless, can have consequences of a far reaching nature for government's ability to manipulate the monetary system, and for the type of economy it may be seeking to establish eventually.

In formulating policies for economic and social restructuring within the framework of the governmental objectives outlined earlier, it is essential, therefore, to recognise the critical elements of the system in terms of deriving a long term strategy. Failure to do so can easily lead, not only to an ad hoc approach to development, but to the adoption of policies which may be in basic conflict with the goals of increasing self-reliance and a stronger economic fabric. The fact that decisions relating to a particular sector tend to have broader implications for the economy as a whole re-

TABLE 7.9

CONTRIBUTIONS BY FINANCIAL INSTITUTIONS TO SELECTED ECONOMIC AGGREGATES, 1973—1977

Items	1973	1974	1975	1976	1977
No. of Persons Employed	**1,916**	**1,958**	**1,987**	**2,173**	**2,184**
Bahamian	1,642	1,690	1,728	1,895	1,929
Non-Bahamian	274	268	259	278	255
	$'000				
2. Government Fees	**1,773**	**1,717**	**1,689**	**3,029**	**3,348**
of which					
(Licence Fees)	(1,994)	(1,171)	(1,095)	(1,145)	(1,176)
(Company Fees)	(424)	(387)	(412)	(1,215)	(1,113)
(Work Permit Fees)	(155)	(159)	(182)	(669)	(1,059)
3. Salaries	**18,249**	**19,081**	**19,829**	**24,728**	**26,591**
4. Administrative & Miscellaneous Expenses	**11,963**	**12,992**	**14,965**	**20,816**	**23,268**
5. Construction Expenditure	**1,695**	**875**	**446**	**686**	**1,998**
Total (2 to 5)	**33,680**	**34,665**	**36,929**	**49,259**	**55,205**

Source: Central Bank of the Bahamas, *Quarterly Review,* March, 1979.

quires a clear examination of the interacting influences between the promising activities from the point of view of growth and development, and those that provide some short term benefits but offer little hope as a secure basis for future national well-being. In this connection, the critical concern would appear to be the adoption of an approach in which the competitive ability and general vibrancy and potential of the former is not sacrificed within a framework overly influenced by the latter.

Past policies have often sought justification on the cliché that the country has no mineral resources and therefore has had to adopt a very accommodating posture (a perception that is now deeply ingrained in the national ethic) for economic survival. The truth of the matter is that with respect to such natural resources with which the country is so well endowed, there has never been a strategy or a consistent set of policies for their use and exploitation in the long term interest of Bahamians, with the result that the country finds itself in the position of having to look more and more to the outside world for sustenance, and, therefore, has to fashion its policies accordingly. Such an attitude, as has been repeatedly pointed out, leads to greater and greater external dependence with tragic consequences for social and economic development.

Government's Policy and the Role of the Financial Sector

Though this study is mainly concerned with the structure and orientation of the financial system, the above discussion has been necessary as a frame for our next topic which is concerned with the perception of the role of financial sector in the development process, and the problems of resource mobilisation from the public sector angle.

The development of the financial sector is not an end in itself. It is but a means to the higher objective of transforming the economy and attaining for the citizens of a country a better standard of living. The critical role which financial institutions have to play in this process is now widely recognised, and it is precisely because of this that so much attention has come to focus on their operations and general orientation in recent years. Traditionally, the major part of banking, insurance and other financial services in many developing countries has been provided by extensions of foreign firms operating out of metropolitan centres with the primary aim of maximising total profits. Within this overriding objective, the needs of the local economy took a secondary place and any benefits were purely incidental.

With the attainment of independence and the responsibility assumed by national governments for social and economic development, growing pressure has been brought on financial institutions to change their policies in ways consistent with objectives formulated by the country in which they are located. In this context, while some governments have resorted to exchange control measures and insisted on certain organisational changes, as part of the local restructuring effort, others have seen it fit to completely nationalise foreign undertakings or to impose rigid restrictions on their local activities. In the Commonwealth Caribbean, for example, growing economic problems and the intense social and economic pressures built up in the post-independence period, have spurred efforts aimed at bringing important financial institutions within the framework of the development process. Adaptation to an increasingly nationalistic environment has in some instances meant changes in the ownership structure of commercial banks, allowing for a measure of local participation or control. Some of the banks themselves seem to have recognised the need for changes in their traditional mode of operation. The Royal Bank of Canada, for example, in its 1972 annual report in explicit reference to its experience in Trinidad and Jamaica concluded as follows:

> *It is a fact that the division between domestic and international banking is becoming less definite. But one clearcut difference emerging is that the branch system*

in which we operate in Canada is not the way of our future abroad. With each year the trend to establish and develop affiliations with various financial institutions, rather than operate network of branches gains momentum.

It might be noted in passing, however, that from the host country's point of view, a switch of operation to a domestic-formed company does not in itself ensure a radical change in policy, even when there is some degree of local participation, and further measures may have to be contemplated to achieve the desired changes.

While foreign entities often have to bow to local pressures in ways indicated above, for various reasons, they generally prefer to retain complete control over their operations and policies. In the Bahamas, there has apparently been no attempt so far to persuade the commercial banks to undertake changes in structure which might accommodate some degree of local participation. In the field of lending, the banks up to now have been free to determine their own priorities, and though official concern has been expressed about the pattern of lending from time to time, the banks have not been subject to serious pressure in this respect. Government, so far, has been content to confine itself to appeals, which on occasions have been dramatised to the point where the survival of the nation has been hinged on the availability of funds to the public sector in order to carry out certain development projects.[72]

In respect of Government's attitude towards the financial sector and to the banking concerns in particular, we need to make a few observations. As indicated earlier, it is essential to distinguish between the domestic operations of financial institutions located or domiciled in the Bahamas and their offshore activities, if the development effort is not to be thwarted by a shortage of capital resources. While, as we have also said before, there is logic in permitting the freedom accorded operations in the latter sphere, it seems totally self defeating that Government should refrain from introducing some direction in the use that is made of locally generated funds, or should be unwilling to lay claim to part of the income derived from the employment of these resources. In the past, and even at present, there seems to have been, and still is, some kind of tacit presumption on the part of the authorities that adoption of such policies somehow conflicts with the tax haven image of the country, even if only in a psychological sense. With the state's expanding role in trying to foster economic development, and with its growing social responsibilities, there is urgent need for a rationalisation of the situation.

In conclusion, there are two further points we need to make in relation to Government's policy and its approach to the question of development. In an earlier paragraph it was stated that the financial sector was generally viewed as a means to an end. In the Bahamas, financial activities tend to be seen as an end in itself, and this is no doubt the major factor influencing Government's attitudes and dealings with institutions located in the country. It also explains why the authorities have been more concerned with the solvency of the financial sector and the greater employment of Bahamians than with such things as the direction of funds passing through it or the cost and availability of resources to Bahamians engaged in or contemplating productive enterprises. While the Government appears to be sincere about its policy of economic control and participation of Bahamians in the economy, far too little attention has been paid to instruments and policies that could attain these ends. This in a sense reflects a failure to articulate a long term development strategy with clearly defined objectives.

The second point which should be made concerns the relationship between the government and the community within the context of the kind of problem confronting the society, and the goals the government has embraced from the standpoint of development. While the scope of Government's operations vary from country to country, there are certain functions and responsibilities which tend to be the peculiar concern of the state, and which cannot be left to the private sector. Such undertakings like the provision of adequate school places and hospital facilities, the construction and maintenance of roads, and the development of water and power supplies are clearly too important to be left to the whims of private concerns, and particularly in a developing country where a large section of the population is too poor to be able to purchase some of these services. In such circumstances the responsibility of the government is an unmistakeable one, and the role of the fiscal system becomes critical in this situation. The taxation system in particular has a key role to play in making available to Government the necessary resources to perform its function. Borrowing (both locally and abroad) and printing money are also important in this context, but these sources, as we have pointed out earlier, the latter in particular, have certain disadvantages attached to them and therefore have to be resorted to with care.

The formulation and implementation of a proper tax system, taking into consideration such factors as equity, administrative convenience, and the effects on efficiency, saving and investment is not an easy task in any circumstances, and particularly in a situation where there are policy and institutional limitations. In the Bahamas, the recent introduction of National Insurance will undoubtedly provide the government with some funds, but this, it should be emphasised, is no substitute for fiscal instruments touching a wide section of the economy, which could be used to achieve a broad range of social and economic objectives in the dynamic process of change and development.

As we have indicated earlier, it is quite possible for the Bahamian Government to impose a corporation tax on income generated from local sources, both in the real and financial sectors, without jeopardising its tax haven status.[73] This could also be supplemented by a capital gains tax, particularly as it applies to real estate activities from which Government derives very little income at present, and which involves one of the most important resources of the country. Since residents (Bahamians and non-Bahamians alike) benefit directly and indirectly from Government's expenditure, it is not at all unreasonable that they should be asked to make a more meaningful contribution to the public purse in accordance with the size of their wealth or income. Since Government is unwilling to impose a personal income or wealth tax, there are other ways of achieving this objective, without offending the sensitivities of people who are allergic to these kinds of measures. A common method, of course, is the levy of a sales tax on a select range of goods, the rate increasing with the character of the good, in terms of its 'non-essentiality'. Another instrument which bears some resemblance to the sales tax and which is worth some consideration in the Bahamian context is the expenditure tax proposed by Nicholas Kaldor[74] and several others before him. The expenditure tax, as the name implies, is based on spending and, as such, saving is exempted from taxation, which is a salient feature of the system.[75] Like the income tax, the rate can be made progressive by exempting certain essential expenditures and increasing the rate correspondingly as spending on non-essential goods increases. Unlike sales and other indirect taxes, which are collected from distributors and manufacturers, the expenditure tax is collected directly from individuals like the income tax. Unlike the latter, however, which can be deducted at source, a tax based on spending obviously involves a greater amount of difficulty in terms of assessment and collection. Despite this shortcoming, in a situation where there is no income tax and where private savings need to be encouraged,[76] an expenditure tax is well worth considering.

Concluding Observations

A great deal of effort in recent years has been expended in not only trying to enhance the image of the Bahamas as a reputable tax haven, but in increasing existing incentives and facilities in order to attract a wider range of business. There is no doubt that tax haven activities make a contribution to the economic life of the country and, given existing constraints and potential, the Government is justified in trying to exploit the benefits to be derived from the Bahamas' position as a leading tax haven and offshore centre. Dependence on tax haven actitivites, however, has to be seen in a long term perspective. The developed countries, whose citizens and corporations provide the bulk of the business for tax havens, view the latter with a great deal of suspicion, (given that their tax base is at issue), and are constantly trying to close legislative loopholes which permit the use of tax avoidance techniques. The existing suspicion by tax authorities in the developed countries is also fuelled by a feeling that tax heavens are used to flout the law, and this, more than anything else, explains the intense effort to penetrate the secrecy screen of tax havens. Tax havens continue to exist (and in many cases prosper) because individuals and corporations are constantly finding new ways in which the facilities offered can enhance their operating flexibility and manoeuvrability.

The future course of anti-tax haven measures and counteractions is difficult to predict. The inherent uncertainty in this situation is one which should not encourage countries to place significant reliance on tax haven business as part of any long term strategy of development. Even with respect to offshore financial business there are moves in certain major financial centres to encourage their banks to conduct such operations from onshore locations.[77]

It is worth pointing out that volatility also arises from the existence of so many tax havens. The slightest suspicious development in a particular haven, with respect to tax or secrecy arrangements, may mean a flight of business to other sanctuaries.

FOOTNOTES

1. Webster's Third New International Dictonary.
2. See J. Van Horn Jr., "The Use and Abuse of Tax Havens" in J.F. Avery Jones (ed.), *Tax Havens and Measures Against Tax Evasion and Avoidance in the EEC,* London, Associated Business Programmes, 1974 .
3. See Thomas Kelen "The World of Offshore Finance" in *The Banker,* April, 1977.
4. It should be stressed that the absence of taxes by itself is not a sufficient condition for the establishment of an offshore financial centre. This may explain why not all tax havens are financial centres. Mark Borsuk outlines six conditions which he feels are prerequisites for the development of an offshore capital market.

    (a) Minimum impostion of taxes e.g., no withholding taxes on interest arising from deposits of non-residents;

    (b) Freedom from exchange controls at least on non-resident funds;

    (c) A sophisticated financial infrastructure;

    (d) Political stability and freedom from confiscatory measures;

    (e) A sophisticated communications network linking all major financial markets;

    (f) A favourable geographical and time zone position.

    One might add to these a proper supervisory system of control over financial institutions. See "The Future Development of Offshore Capital Markets in Asia" in *The Columbia Journal of World Business,* Spring, 1974.
5. It should be pointed out that these centres also serve as important bases for offshore transactions.
6. See A.A. Shenfield, *The Political Economy of Tax Avoidance,* London, The Institute of Economic Affairs, 1968, p. 7.
7. This situation has led high tax countries such as the United States and certain EEC members into a frantic effort to get certain prominent tax havens to enter into bilateral treaties which would oblige the governments concerned to furnish information in cases where criminal activity is suspected.
8. Under the Hawksbill Creek Act (operative in Freeport only) licensees are exempted from taxes on income, capital gains, real estate and personal property until 1990. Freedom from customs duties (except on imports for personal use), excise and stamp taxes is guaranteed until 2054. In the case of the Industries Encouragement Act, approved enterprises are exempted from taxes on all earnings for a period of 15 years, effective on the date the industry is approved and registered. This is in addition to reliefs in the form of exemption from all duties and taxes for plant machinery, tools, equipment, raw materials and components required by the enterprise. The Hotel Encouragement Act exempts promoters of new hotels (meeting certain specifications) from all taxes on earnings for 20 years. This Act also provides relief from real property taxes and from customs and other import duties levied on materials and furnishings imported for purposes of constructing and equipping hotels.
9. It can be argued all countries are tax havens to some degree. Even the United States grants tax exemption to certain types of transactions. For example, interest paid to foreigners on U.S. bank deposits do not attract any income tax.
10. Jean Doucet and Kenneth Good, "What Makes A Good Tax Haven", *The Banker,* May, 1973.
11. This should be modified to read no taxes of a particular kind (e.g., income tax, profits tax, corporation tax, capital gains tax, etc). Fiscal measures such as import taxes, stamp duties and fees of various kinds are used to raise revenue for public purposes.
12. Commonwealth Caribbean countries can also be placed in this group on the basis of the tax exempt arrangements offered to companies engaged in certain types of activities. Besides the

incentives extended to entities engaged in domestic operations, Jamaica, Barbados and Antigua also have in effect legislation designed to attract companies carrying on the bulk of their business outside their respective borders.

13. It may be argued that to the extent that the activities of tax havens do not involve a criminal breach of the laws of other countries, there should be no reluctance on the part of the former to enter into bilateral treaties with other governments desirous of establishing arrangements which might serve to discourage the widescale violation of their tax laws. A dilemma here, of course, is that even where a transaction is of quite a legitimate nature clients often seek anonymity and secrecy, and this consideration no doubt explains a major part of the reluctance of certain tax haven governments to enter into bilateral treaties.

14. The technique employed was to transfer land to someone else legally capable of owning it, and directing that it be held "for the use" of some ecclesiastical institution. See Gerald Jantecher, *Trusts and Estate Taxation,* Washington, D.C., The Brookings Institute, 1967, p. 17.

15. G.W. Keeton, *The Law of Trusts, A Statement of the Rules of Law and Equity Applicable to Trusts of Real and Personal Property,* London, Pitman and Sons Ltd., 1968, p.1.

16. W.J. Mowbray, *Lewin on Trusts,* 16th ed., London, Sweet and Maxwell, 1964, p. 3.

17. Keeton, *op. cit.,* p. 5.

18. See 1972 Annual Report of the Trust Corporation of the Bahamas Limited.

19. See for example C.W. Adams, "Secrete Account or Foreign Trust?", *The Banker,* Vol. 22, No. 254.

20. While the secret account facility does not exist in the Bahamas at the moment, there are several private banks in the Cayman Islands which are imitating Swiss institutions by offering numbered accounts. The bank secrecy law assures complete anonymity. Such combining of two different traditions is a relatively new phenomenon.

21. Even in jurisdictions that have a trust law, this is a very important instrument, as would have become clear from earlier chapters.

22. Accumulations Act, 1800.

23. Milton Grundy, ' The Offshore Trust", *The British Tax Review,* 1971.

24. Comment made with reference to the Bahamas Trustee Law which, incidentally, is almost identical with the English Trustee Act of 1893. See Bahamas International Trust Company Booklet (by the same title) August, 1972, p. 5.

25. After three years the tax free allowance rises to $25,000.

26. See Caroline Doggart, *Tax Havens and their Uses,* 1979 edition, London, EIU, p. 66.

27. Roger Bearwood, "Sophistication comes to Tax Havens", *Fortune,* February, 1969.

28. For a lucid presentation of the main provisions of this Act. See Price, Waterhouse and Co., *Information Guide for U.S.Corporations Doing Business Abroad,* New York, January, 1972.

29. It is thus possible that with shareholding of less than 10 per cent each, U.S. shareholders can control a foreign company which will not be classified as a controlled foreign corporation for purposes of the Act.

30. See Price, Waterhouse, *op., cit.*

31. It should be pointed out that there are other broad criteria determining the definition of foreign base income and the extent of tax liability e.g. the proportion of gross, foreign base company income to total gross income of the CFC and the disposition of base income originating in less developed countries.

32. *Beardwood, op., cit.*

33. Milton Grundy, "Tax Havens", *The British Tax Review,* 1967.

34. Bearwood, *op., cit.*

35. J.T. Wooster and C.R. Thoman, "New Financial Priorities for MNC's" *Harvard Business Review,* May-June, 1974.

36. *Ibid.*

37. J.C. Barker and T.H. Bates, *Financing International Business Operations,* Scranton, Intext Educational Publishers, 1971, p. 52.

38. In the case of the Cayman Islands, tax-free status was conferred for all time in a special decree made by King George III in the eighteenth century out of admiration for the courage displayed by the islanders in rescuing the crew of a Royal Navy fleet of 20 ships, which was wrecked on nearby coral reefs.

39. A Bahamian Company is defined as one which is at least 60 per cent beneficially owned and controlled by Bahamians.

40. If one of the purposes of the tax is to discourage speculation, there seems to be little justification why undeveloped properties owned by Bahamians should be excluded. There is an additional problem in this situation, and this stems from the fact that Bahamians can be used in a fronting capacity for foreigners who may wish to speculate without incurring tax liability.

41. The rate structure is as follows. On the first $20,000 of assessed value: ½ of 1 per cent per annum; on the next $30,000 of assessed value: 1 per cent per annum; on assessed value in excess of $50,000 1½ per cent per annum.

42. In computing the 'gross winnings' in respect of any period, the law requires that "the value of any cheque or the amount of any promise to pay money, given to the casino or of any credit extended to any person by the casino shall be taken into account as money received by the casino on the day on which such cheque or promise is given to or such credit is extended by the casino".

The annual rate (since 1/1/74) on which the tax is based are as follows:

On gross winnings up and including $10 m.	25%
On gross winnings in excess of $10m. up to and including $16 m.	20%
On gross winnings in excess of $16m. up to and including $20m.	10%
On gross winnings in excess of $20m.	5%

The minimum winnings tax payable in any year by a casino is $2m.

It should be pointed out that since the beginning of 1978 all casinos in the Bahamas have been owned by the Government through the Hotel Corporation.

43. A 3 per cent tax on hotel room rates was added from 1 January, 1979 as part of a larger tax package.

44. This in addition to initial registration fees and stamp taxes. Stamp duty paid ito Government on the formation of a Bahamas Company begins at $60 for companies with a capital of $5,000 or under. An escalating fee is in operation. The actual figure paid depends on the extent of capital (share and loan).

45. There are also initial and annual registration fees for agents, brokers and salesmen.

46. The maximum for any one year is $5,000.

47. The rates applicable since the beginning of 1977 to real and personal property of Bahamians and/or Bahamian companies are as follows:

    a) where the value of the conveyance exceeds $30,000, but does not exceed $50,000, 3½ per cent of the value,

    b) where the value of the conveyance exceeds $50,000, but does not exceed $100,000, 4½ per cent of the value;

    c) where the value of the conveyance exceeds $100,000, 5½ per cent of the value.

Where land is sold to non-Bahamians and/or non-Bahamian companies the rates are twice the rates applicable to land sold to Bahamians and/or Bahamian companies. The distinction between real and personal property has been abolished thus personal property now attracts the same rates as real property.

48. U.K. Hicks, *Development Finance*, Oxford; OUP, 1965, pp. 67–68.

49. It should be noted, however, that in recent years the approach to taxation has, in a sense, become less ad hoc as a result of the Government's determination to promote the country as a leading tax haven. The effect of this policy, of course, is that the tax system has to be kept structured in a particular way if the country is to attract tax haven business.

50. There is no hard and fast distinction between direct and indirect taxes, which is no more than an administrative classification. One criterion widely used in distinguishing between these two groups relates to the question of whether the tax can be shifted or not. If it can, the tax will

often be classified as an indirect tax; on the other hand if it cannot, it will be labelled as direct. Taxes, however, which are commonly classified as direct or indirect cannot always justify their label on the basis of shiftability criterion. There may be occasions, for example, when an income tax can be shifted; in the same way it cannot be maintained that a sales tax can always be shifted. Whether or not a tax can be shifted and the extent to which it can be shifted depends on various factors, not the least of which is the strength of the parties concerned in the market place.

51. See U.K. Hicks, *op. cit.*, p. 69.

52. This is only one measure of national income that is often used in calculating the tax/national income ratio. Other versions include Gross National Product, Net National Product and National Income. Some writers prefer the GDP concept reasoning that foreign incomes generated locally can be taxed. Others prefer Net National Product, arguing that GDP (or GNP) includes allowances for capital consumption which are normally not subject to tax. National income is often not considered because it excludes indirect taxes which are included in the numerator.

53. A major problem in comparing such proportions for various countries arises from the different approaches that may be used in compiling national income aggregates.

54. If we include social insurance contributions (particularly for the developed countries) the tax/GDP ratios would obviously be much higher. If this is done for the U.K., for instance, this country's 1976 ratio would increase from 25.9 per cent to 32.8 per cent.

55. Colin Clarke, "Public Finance and Changes in the Value of Money", *Economic Journal*, December, 1954.

56. It should be pointed out that Clarke was speaking in the context of what he called a 'non-totalitarian community in times of peace'. It should be noted, too, that the statistical material used by him to arrive at this conclusion, related for the most part to the industrial countries.

57. See R.M. Sommerfield, *Tax Reform and the Alliance for Progress* , Austin, University of Texas Press, 1966, p.46.

58. There is no local government in the Bahamas. The Central Government directly controls all public revenue and expenditure transactions.

59. The income of the National Insurance Fund in 1977 amounted to $23 million. This was 18.4 per cent of tax revenue. If the insurance contributions were to be added to tax income in that year, the tax/GDP ratio would increase from 15.7 per cent to 18.5 per cent.

60. 'Elasticity' is generally defined as a measure of the degree of responsiveness of one variable to changes in another. In the context of our discussion, we can theoretically derive a measure of elasticity of the tax structure (base and rate schedule remaining unchanged) by dividing a relative change in tax yield (R) by a relative change in national income (Y). An elasticity of 1 implies that a 10 per cent increase (decrease) for example, in national income will result in a 10% increase (decrease) in revenue. An elasticity of 2 means that R will change by twice times the percentage change in Y in the same direction. As can be seen in Table 7.5 even when revenue yields resulting from changes in the tax rates are included, the tax system is a relatively inelastic one, elasticity amounting to 1.3 for the period 1969-77. Of course the responsiveness of the various types of taxes will be different, given the differences in the nature of the rates involved.

61. Graham Hockley makes a crucial distinction of these words: "Internal borrowing is a re-arrangement of assets: citizens surrender current pur[illegible]asing power in return for government securities. No increase of real resources is directly created as a result. External borrowing on the other hand, permits an import of real resources either of consumption or capital goods. Likewise interest and repayment of internal debt is the transfer of current purchasing power back to holders of the debt. Interest and repayment of external borrowing mean however, a corresponding outflow of goods and services . . . From the point of view of interest and repayment of external debt, it can be said that this constitutes a 'burden' on future output of goods and services. However, it must not be lost sight of that if the borrowing is used to increase the productivity capacity of the economy, this may create the capacity not only to do both of these things, but also to yield a return over and above this". See Graham C. Hockley, *Monetary Policy and Public Finance*, London, Rouledge & Kegan Paul, 1970, p. 215.

62. See Dragoslav Avramovic and Associates, *Economic Growth and Foreign Debt*, Baltimore, The Johns Hopkins Press, 1964, pp. 40—41.

63. The entire current account is sometimes used.

64. See the World Bank *Annual Report*, 1979.

65. See Douglas A. Scott, "External Debt-Management Policy in a Developing Country" in Tom J.

Farer (ed), *Financing African Development*, Cambridge, MIT Press, 1965, p. 58.

66. See Dragoslav Avramovic and Associate, *op. cit.*, p. 42.

67. Scott, *op., cit.*

68. *Independence for the Commonwealth of the Bahamas, op., cit.*

69. *Ibid.*, p. 25.

70. Such tax arrangements are normally supplemented by the absence of exchange controls and investment regulations on external activities.

71. The comparable figure for 1975 was estimated to be 5,099. It should be pointed out that these figures are exaggerated to the extent that they include people engaged in real estate and business services.

72. See address by Mr. Carlton Francis, former Minister of Development and former Chairman of the Bahamas Development Corporation, to the Bankers' Club on 3 July 1974.

73. In such an event it would then become necessary, and desirable, to scale down the level of import levies, particularly on raw materials, equipment and other essential goods of both a consumption and capital nature, as part of the nationalisation exercise.

74. Nicholas Kaldor, *An Expenditure Tax*, London, Allen and Unwin, 1955.

75. However, if spending exceeds income and the deficit is financed by dis-savings and/or borrowing, the latter will of course fall within the base of the tax.

76. A frequent criticism made of an expenditure tax as it relates to upper income group saving is that it would encourage the concentration of private capital. It has been suggesed that this problem might be dealt with by levying personal property taxes or by a system of highly graduated property taxes. See A.R. Prest, *Public Finance in Developing Countries*, Trowbridge, English Language Book Society, 1975, p. 81.

77. In New York, for example, the state legislature has already passed tax legislation designed to exempt eligible international transactions conducted at domestic banking offices from state and local taxes. A proposal has also been submitted to the Federal Reserve Board by the New York Clearing House Association to have deposits arising from international business involving non-U.S .residents exempt from interest rate restrictions and reserve requirements. If these proposals are accepted, the effect may be that a large part of the banks' international business currently conducted at their overseas' branches will be attracted back to the U.S. See E.D. Short, "How to Abolish Tax Havens" in *Euro-money*, December, 1978.

    It might be noted, too, that in 1978 Florida passed the International Banking Act which many observers feel is the first step towards the development of an offshore banking centre.

CHAPTER 8

SUMMARY AND CONCLUSIONS

The experience of poor countries in the post-war period points to the fact that the development problem is a very complex one. The factors involved touch every facet of human existence. Partial approaches, therefore, attain only limited effect. There are, of course, crucial variables and factors which may attract attention either in formulating solutions or in examining the effects of particular policies and decisions. Change, it is widely recognised, has both quantitative and qualitative dimensions and valid conclusions often, therefore, depend on a comprehensive examination of all related areas of concern in the particular context. The approach to development, of course, differs widely from country to country. Strategies and policies tend to be informed not only by the perception of their effectiveness in other contexts, but perhaps more so by existing internal conditions and the awareness of the historical, economic and political processes which have influenced and shaped these conditions. Size (both in terms of population and area) and resource endowment often tend to be important parameters in determining both the pace and type (path) of development.

For the above reasons, any real appreciation of the nature of the development problem facing individual countries or their development prospects depends to a significant extent on particular analysis and study. Solutions and recommendations, if they are to be relevant, can only be put forward on this basis. Generalisations drawn from a wide range of experiences are not unimportant to case studies, especially in helping to put issues in perspective or in conceptualising a development framework in a given context. Peculiar internal conditions, however, determine the limits of their use.

As a newly independent country, the politics of the Bahamas revolve largely around the economics of development. On the basis of an amalgam of activities, which have emerged partly by design and partly by accident, the country has been able to attain a relatively high per capita income compared to other developing nations. The features of underdevelopment, however, are all there. These include, among others, dependence on a narrow range of economic activities (as well as a narrow range of markets), a high level of unemployment, a highly skewed distribution of income, inadequate social services (education, housing, medical facilities, etc.), a lagging food producing sector, a low savings ratio and an underdeveloped domestic money and capital market. Attempts to deal with these problems combined with a growing nationalism have resulted in an increasing governmental presence and intervention in the economy, reflecting the increased social responsibilities which have come to bear on the central administration. Even in a 'normal' setting where the authorities are equipped with the whole gamut of fiscal and monetary instruments, there appears to be no easy solution to the problems described. Seen against the resource endowment of the Bahamas, the administrative handicaps and the nature and history of the country, they take on particular significance.

It has to be pointed out, however, that while there are, indeed, natural limitations to the development possibilities facing the Bahamas, the country does have a certain kind of potential, based largely on its 'sun, sand and sea' resources. These assets, if properly exploited, can generate the necessary employment and provide the average inhabitant with a high and sustainable standard of living. This, of course, as has been repeatedly pointed out, calls for a particular type of framework and the articulation of a set of policies designed to lead to the optimum use of the country's resources as seen from a national viewpoint. An underlying assumption here is that the necessary confidence can be generated which can break the syndrome of dependence which has engulfed the Bahamas. The moves towards national participation and control are, undoubtedly, measures in the right direction, as is the selective approach towards the question of foreign investment. A policy of greater local ownership should be supported by a properly functioning local stock exchange of some sort. The feasibility of setting up such an institution should be investigated, though it should be quickly pointed out that this in itself does not necessarily guarantee an acceleration of the localisation or ownership dilution process.

With respect to the view prevailing in some quarters that unrestricted foreign investment provides the panacea for all the country's ills, the arguments need to be critically examined. The theoretical benefits of private foreign capital often far outweigh what obtains in practice. In the short term, certain problems (e.g. a foreign exchange shortage and unemployment) may be alleviated. Contributions in the form of increased export earnings, assured foreign markets, the development of linkage industries and the transfer of technology tend to materialise in a limited sense only, if at all. The subsequent outflow of profits and dividends associated with foreign capital creates a situation of continuing dependence. Even if income accruing to the foreign concern is reinvested (in the form of equity in existing or new enterprises), this has the effect of increasing the foreign presence in the country and paves the way for even greater subsequent outflows. The latter may eventually grow to a point where they exceed new inflows. A growing consciousness of the pitfalls associated with foreign investment has led many countries to intensify their efforts in mobilising domestic resources and financing foreign materials and equipment through borrowing to the extent that this is possible. There is nothing intrinsically wrong in foreign (or even local) borrowing. The guiding principle is the ability to repay which, of course, is not unrelated to the question of the way the funds are spent. If loan resources are used to expand the productive capacity of the economy, part of the increased income generated can be recouped through the tax system to repay the debt. This assumes that the fiscal structure is of a kind that would enable it to perform this role. Where debt has to be repaid or serviced in foreign currency, special attention would, of course, have to be paid to the foreign exchange earning capacity of the country, or a situation may arise where future borrowing is done mainly to repay or service past loans. Governments can also borrow with the object of making such funds available to private enterprises on a loan basis through one of its several agencies. This latter function assumes critical importance in a situation where private entrepreneurs find it extremely difficult to raise funds on their own.

The essential difference between financing through borrowing and foreign private investment is that once the loan is repaid the plant or project financed remains under national control. It may be argued that the inflow of private capital is often accompanied by other assets such as management, know-how, technology, etc. This is a crucial consideration, particularly in situations where these qualities are lacking. Very often, however, foreign investment is motivated more by the desire to capture the local market, to exploit cheap labour, to take advantage of a strategic location or to control an important resource rather than to contribute to domestic development. One has to take a discriminating look at this question. The absurd situation existed in the past where even foreign speculation in the country's land resources was encouraged as a form of private foreign investment. Perhaps it should be pointed out here that when speaking of foreign investment reference is not being made to the large number of foreign entities which are registered in the Bahamas to take advantage of the tax haven facilities offered by this country. The number of such entities provides neither an indication of the level of foreign investment in the country nor a guide to the state of economic activities, since their resources are generally employed outside the Bahamas.

It was indicated in the study that while other activities contribute to the economic life of the country, tourism plays the central role. It is recognised that tourism, by its very nature, is an activity that leaves a country dependent on it highly exposed to external conditions. It might be argued that the same observations could be made with respect to certain primary activities on which many developing countries depend. Some observers go further and contend that in some senses it is less volatile than certain industries. For while it is relatively easy for a country to impose restrictions on foreign goods entering its market, it is much more difficult to prevent its residents from travelling to particular countries. The added observation is made that tourist dependent economies have fared relatively better in the economic crises following the increases in oil prices since 1973 compared to non-tourist economies (excluding the oil producers). One of the main problems with tourism, of course, is that there are features associated with it which are not considered desirable from a social point of view.

The Bahamas, as pointed out, has all the assets for a vibrant tourist industry, and, given the absence of mineral resources and the present limited scope for other activities, one can understand the concern to protect and cultivate it. There is need for changes, however, both in approach and policies if the full potential of the industry is to be realised. While the study has sought to suggest some broad guidelines for the reorganisation of the tourist industry, its main concern has been with the financial sector and its relationship to real development. There are, as indicated, two aspects to this sector: one arising from domestic operations, and the other from 'offshore' activities. While the latter provides some benefits to the country, the former's role is critical to the future development of the economy. The encouragement of financial activities is not entirely an end in itself. This means that the aspect connected with the domestic operations must be scrupulously distinguished since it may have to be affected by deliberate policies operating against certain defined national objectives. Domestic finance cannot be left to pursue ends as seen from very narrow view points informed principally by profits or safety to an unwarranted extent.

One of the major conclusions to emerge from the study is that greater attention needs to be paid to the uses to which resources generated locally are being put. There is also an urgent need for the creation of a wider range of financial instruments with the accompanying money market conditions, which should not only have the effect of encouraging a higher level of savings, but should also influence the preferences of savers in a way that could lead to a more productive use of financial resources. The more funds that can be generated locally, and the more efficiently these resources are used, the less dependent would the country be on external financing either from private or public sources. Even when foreign funds can be obtained on quite favourable terms, this should not be looked upon as a substitute for the mobilisation of domestic savings, if greater self-reliance is taken as an objective of national policy. It should be pointed out here that financial institutions have a critical role to play in raising the savings level. Legislations provide the broad framework for their functioning, but do not necessarily ensure the quality of performance (in terms of innovation, experimentation and unorthodoxy) that existing conditions might require.

In most developing countries building and re-orienting the financial system are seen as an integral part of the development effort. In some instances, the process has involved not only national participation in foreign owned organisations, but the establishment of local institutions wholly owned by the government and/or by citizens. This latter policy is often instigated by dissatisfaction with the role and operational practices of the established transnational financial enterprises which tend to lack the desired degree of commitment to national developmental objectives. Very often, however, these newly inspired institutions, which are generally designed to challenge the status quo and assist the disadvantage in the society, assume the same postures of the foreign institutions by clinging to the traditional criteria of success. In effect, they tend to feed upon such growth that takes place rather than assume the catalytic role for which they were concevied. A major reason for this situation no doubt is to be found in the miniscule position occupied by the indigenous institutions in the overall structure, which still continue, in many instances, to be dominated (directly or indirectly) by the large foreign organisations which not only have the advantage of being longer established, but also have access to resources which permit a greater degree of flexibility in their operations. Unless attention is specifically directed to defining the operational scope of locally owned institutions within some long term plan, and specific measures are adopted to expand the role and functions of such enterprises in the local system, their position, particularly in a situation of the kind prevailing in the Bahamas, will remain peripheral.

One of the major points we have sought to make throughout the study is that the problem of resource mobilisation and allocation from a development perspective assumes no less importance in the Bahamas than in other poor countries, even though the balance sheet of some sections of the financial sector contains figures of formidable proportions. This latter situation, it was shown, arises from activities that have little to do with the local economy. While, as we have said before, the Bahamas derives certain benefits from the facilities it offers as a financial centre, policies necessary to assist long term growth and development should not be and need not be sacrificed in the interest of retaining the financial haven status of the country. When there appears to be conflict, this should always be resolved in favour of activities which have a domestic base and which, therefore, offers a more secure means of sustenance. There are grave questions surrounding the future of tax haven and offshore financial activities. Even the so-called 'flags of convenience' arrangements are under threat of being eliminated if certain moves within the United Nations Conference on Trade and Development (UNCTAD) succeed in getting the necessary support.

The diversification of the economy and the expanding role of government are issues which are intimately related to the tax structure of the country, and which will have to be rationalised at some stage. Even if one were to argue that the present system is not as regressive as many people think, the increasing need for government revenue still has to be dealt with. A necessary approach to this problem, it is suggested, is the taxation of income derived from domestic activities, (within, of course, a broader tax reform effort), whether they relate to tourism or to the financial sector. In the case of the latter, such a step will require some change in the present accounting systems which tend to integrate the total operations of the various institutions. While it is recognised that it may not be possible to have a complete delineation between domestic and offshore activities, a sufficient degree of separation is no doubt possible to permit the revenue objective to be attained. The completely offshore institutions, of course, will not have to conform to this requirement since (on the basis of their orientation) they will be exempted.

Until the late '60s, when governments in the Bahamas played no more than a peripheral role in the economy, revenue needs tended to be minimal. In a situation where the present-day administration is forced to assume a more active and expansive role not only in combating undesirable social and economic trends, but in instigating the growth processes along premeditated paths by a careful moulding of institutions, mechanisms and instruments, revenue requirements have grown correspondingly with the added responsibilities. This state of affairs has arisen from a deep social concern that has its basis in the recent history of the country, rather than from ideological posturings. Ultimately, the efficacy of a particular development strategy will be judged by its impact on the welfare of Bahamians, rather than by its place in tradition. To the extent that a chosen path falls short in this respect, this will occasion the need for changes and adjustments in certain policy areas, however sacrosanct the latter may seem to be. It is difficult to retain a disposition against change in a world where basic conditions around us are subject to constant mutation.

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