

COMMERCIAL BANK CREDIT IN THE BAHAMAS
1982 - 1989

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T A B L E O F C O N T E N T S

	Page
INTRODUCTION	1
Part I Commercial Bank Credit by Sector	4
Part II Consumer Instalment Credit	16
Part III Macroeconomic Impact of Domestic Credit Expansion	21
Part IV Policy Implications	28
Conclusion	30
Notes	32
Bibliography	34
Appendix	35

INTRODUCTION

The most basic function of a financial system is to provide financial intermediation--that is to accept deposits from economic agents with surplus funds and to provide credit to economic agents which are in deficit. The financial system in the Bahamas¹ is dominated by the commercial banks. Commercial banks, especially Caribbean branches of foreign-owned banks, have a reputation for risk aversion. Shaw and Robinson (1989, p. 4) report the commercial banks in Jamaica during the period 1981 through 1988 utilized three basic criteria in their lending policies: liquidity, security, and safety. While the liquidity and safety criteria help to ensure that the loan will be repaid the security provided on the loan ensures that payment can be made in kind if not in cash. These three criteria have generally applied to the Bahamian case as well (the lending criteria in some cases becoming much less rigid in 1987). A bank will undertake a portfolio of loans which meets the criteria of its particular risk management programme. The three main risks faced by a bank are identified by Greenspan (1989) as the default or credit risk, the interest rate risk, and the liquidity risk.

Commercial bank credit has played an integral role in the development of the Bahamian economy. There is considerable debate and concern focused, in particular, on the allocation of

commercial bank credit in The Bahamas in light of the preponderance of personal credit in the overall allocation. This characteristic presents a challenge to the monetary authorities given the apparent relationship between credit expansion and balance of payments deterioration in an open economy with a fixed exchange rate. An added complication is the fact that the financial intermediation process, though highly developed in the limited sense that there are many banks which accept deposits and extend loans, does not include a broad capital market.

The lack of an organized capital market in which financial securities can be actively traded severely hampers the financial intermediation process. Commercial banks are, de facto, the primary source of credit and typically only a modicum of investment instruments are available. At the end of 1989, for example, the financial system provided \$1.6 billion in loans and advances, of which the former accounted for approximately 70.0%.

The period 1982-1989 presents an ideal time frame in which to examine commercial bank credit and its impact on the Bahamian economy and can be subdivided on the basis of liquidity conditions to examine subperiods 1982-1986 and 1987-1989, respectively. This period highlights some marked shifts in risk management of banks as well as in the flexibility in lending criteria occasioned by, inter alia, increased competition among banks and buoyant economic growth.

The paper attempts to link the changes in commercial bank credit over the 1982-1989 period with developments throughout the economy. This is accomplished by examining, in detail, the distribution and allocation of commercial bank credit along with the macroeconomic considerations and policy implications of these trends.

Part I of the paper presents an overview of commercial bank credit by sector which is extended in Part II with an examination of consumer instalment credit--an area in which credit expanded at a relatively brisk rate in 1987 and 1988. Part III continues with a discussion of the macroeconomic considerations of credit expansion and Part IV outlines some of the policy implications of recent credit developments. Some suggestions are made as to measures the authorities may wish to consider utilizing, to control credit expansion, and in particular, consumer instalment credit.

PART I COMMERCIAL BANK CREDIT BY SECTOR

This section reviews commercial bank credit on a sectoral basis for the period 1982-1989. The expansion in commercial bank credit over this period must be viewed against the concomitant buildup of their deposits. For example, total credit outstanding expanded at an average annual rate of 9.5% between 1983 and 1988 while the deposit base of banks grew on average by 10.7% annually (see Chart I). The increase in financial intermediation occurred along side a 1.5% annual average expansion in real GNP.

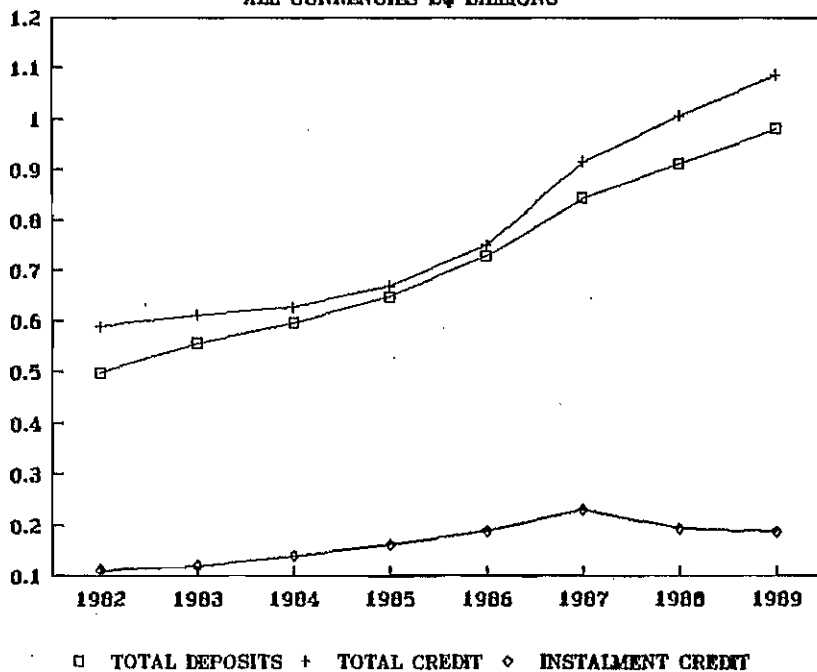
The main factors precipitating the surge in credit in 1987, were a heightened demand for consumer goods on the demand side coupled with favorable liquidity conditions on the supply side. Furthermore, a more intensely competitive environment among banks was occasioned by a new entrant to the local market, resulting in attempts by several banks to maintain or regain market share.

The dominant sector was predictably personal credit which surged during the period. The distribution sector also displayed impressive growth reflecting the increased needs of servicing a larger tourist market but also reflecting the burgeoning local demand for imported goods. The third sector which made notable gains in terms of commercial bank credit was construction. This, again, was partially an accommodation to

CHART I

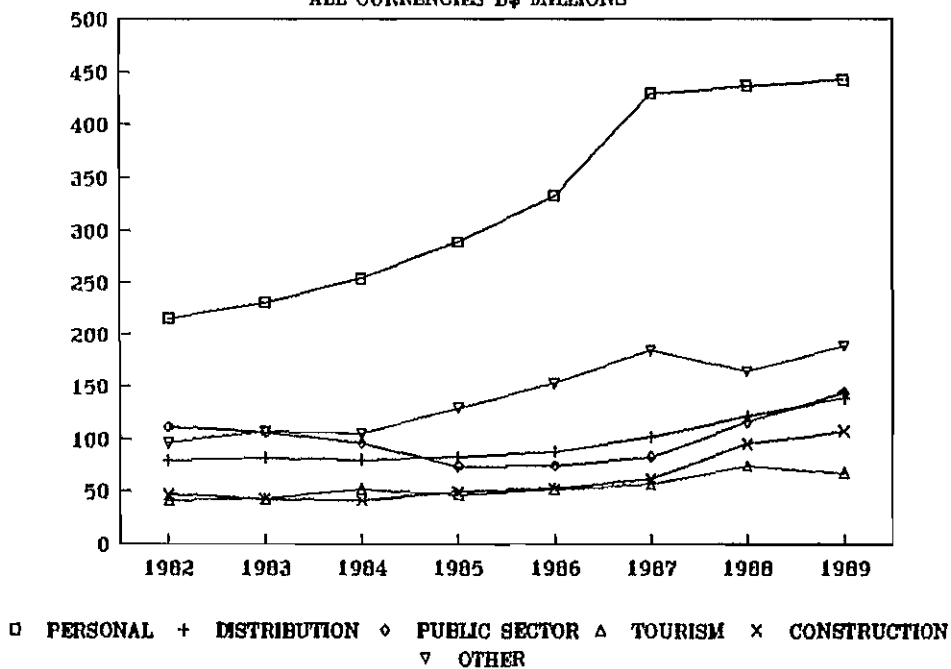
TOTAL DEPOSITS AND CREDIT OUTSTANDING

ALL CURRENCIES B\$ BILLIONS



CREDIT GROWTH IN SELECTED SECTORS

ALL CURRENCIES B\$ MILLIONS



Source: The Central Bank of The Bahamas

renewed consumerism with the construction of two large shopping malls during 1987. From the bank's perspective, this pattern of lending has no doubt been framed against profitability and risk considerations; personal lending usually provides the greatest return (highest interest rate) with relatively low risk vis-a-vis other sectors.

Data on commercial bank credit (loans and advances) outstanding during the period 1982-1989 are segregated into 15 categories according to purpose of loan (see Table 1) and by currency--Bahamian dollars or foreign currency (mostly U.S. dollars). Between 1982 and 1989 total credit grew by \$497.4 million or 84.4%. The major part of this expansion (87.8%) was in Bahamian dollars, which almost doubled by 1989.

In terms of the maturity structure of credit extended, there is substantial difference between Bahamian dollar and foreign currency obligations. Bahamian dollar credit is more heavily skewed toward overdrafts and short-term loans (loans of up to three years) which together accounted for 44.9% of total Bahamian dollar credit in 1989. Medium-term credit (between three and six years) represented 25.1% and long-term loans (over six years) accounted for 30.0% of the total. However, this still indicates a substantial amount of long-term lending by the banking system, in light of the liability structure of commercial bank deposits. For example in 1989, only \$21.5 million

TABLE 1

ALL CURRENCIES B\$ 000

	1982		1983		1984		1985		1986		1987		1988		1989	
	Absolute	%	Absolute	%	Absolute	%	Absolute	%	Absolute	%	Absolute	%	Absolute	%	Absolute	%
AGRICULTURE	2,248	0.4	2,469	0.4	2,281	0.4	2,642	0.4	2,443	0.3	3,021	0.3	3,847	0.4	4,982	0.5
FISHERIES	3,173	0.5	3,490	0.6	3,383	0.5	3,720	0.6	3,175	0.4	5,568	0.6	5,005	0.5	5,548	0.5
MINING & QUARRYING	398	0.1	291	0.0	246	0.0	22	0.0	549	0.1	361	0.0	490	0.0	749	0.1
MANUFACTURING	13,442	2.3	13,312	2.2	13,054	2.1	27,187	4.1	39,872	5.3	49,995	5.5	39,803	4.0	48,654	4.5
DISTRIBUTION	78,582	13.3	81,345	13.3	79,224	12.7	81,987	12.3	87,623	11.7	101,500	11.1	121,096	12.0	138,253	12.7
TOURISM	41,001	7.0	43,022	7.0	51,693	8.3	46,752	7.0	51,906	6.9	56,550	6.2	74,023	7.4	67,160	6.2
ENTERTAINMENT & CATERING	15,163	2.6	18,265	3.0	15,046	2.4	17,893	2.7	21,260	2.8	22,452	2.5	23,869	2.4	24,404	2.2
TRANSPORT	13,927	2.4	13,533	2.2	13,599	2.2	14,884	2.2	17,960	2.4	18,838	2.1	11,325	1.1	11,504	1.1
CONSTRUCTION	47,162	8.0	42,681	7.0	41,040	6.6	49,160	7.4	52,254	7.0	61,547	6.7	95,006	9.4	107,013	9.8
GOVERNMENT	60,166	10.2	72,751	11.9	70,795	11.3	63,659	9.5	58,498	7.8	54,492	6.0	75,792	7.5	61,411	5.7
PUBLIC CORPORATIONS	50,687	8.6	33,276	5.5	24,891	4.0	9,590	1.4	15,613	2.1	27,955	3.1	39,999	4.0	81,842	7.5
FINANCIAL INSTITUTIONS	2,162	0.4	2,634	0.4	1,573	0.3	2,352	0.4	4,344	0.6	3,978	0.4	1,849	0.2	4,732	0.4
PROFESSIONAL & OTHER	30,692	5.2	35,228	5.8	33,986	5.4	37,949	5.7	40,877	5.4	54,028	5.9	65,802	6.5	69,447	6.4
PERSONAL	215,273	36.5	230,642	37.8	253,745	40.5	288,661	43.2	333,005	44.3	429,391	46.9	436,686	43.4	442,115	40.7
MISCELLANEOUS	15,060	2.6	17,577	2.9	21,334	3.4	21,685	3.2	21,845	2.9	26,052	2.8	11,891	1.2	18,731	1.7
TOTAL	589,136	100.0	610,516	100.0	625,890	100.0	668,143	100.0	751,224	100.0	915,728	100.0	1,006,483	100.0	1,086,545	100.0

Source: The Central Bank of The Bahamas

(2.2%) of total commercial bank Bahamian dollar deposits were of a fixed maturity of over one year.

Foreign currency loans, on the other hand, are concentrated in the longer end of the market; long-term credit accounted for approximately 46.9% compared with 16.5% short-term credit and 36.6% in medium term credit. The significance of long-term foreign currency credit is attributed to the preponderance of loans to government and the rest of the public sector (37.8 percent in 1989)--usually considered low risk; and to the tourism sector, primarily loans for hotel construction (14.6% in 1989).

The following provides an analysis of credit by sector. See Chart 2.

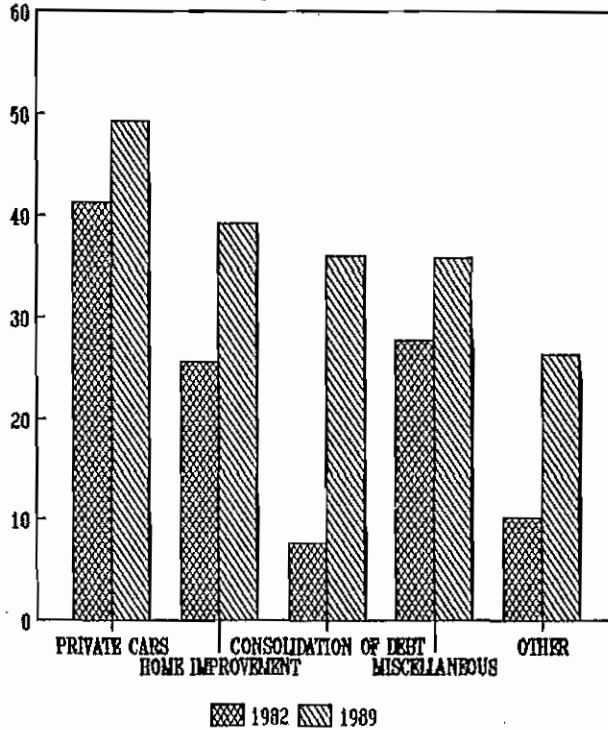
(A) Personal

Historically, personal credit has been allotted the largest proportion of total commercial bank credit. Lending rates on these loans are generally higher than on other types of loans, thereby improving the potential profitability of banks. At end-1989, for example, the average rate on consumer loans was 4.7% and 4.2% higher than those for other local loans and commercial mortgages respectively.

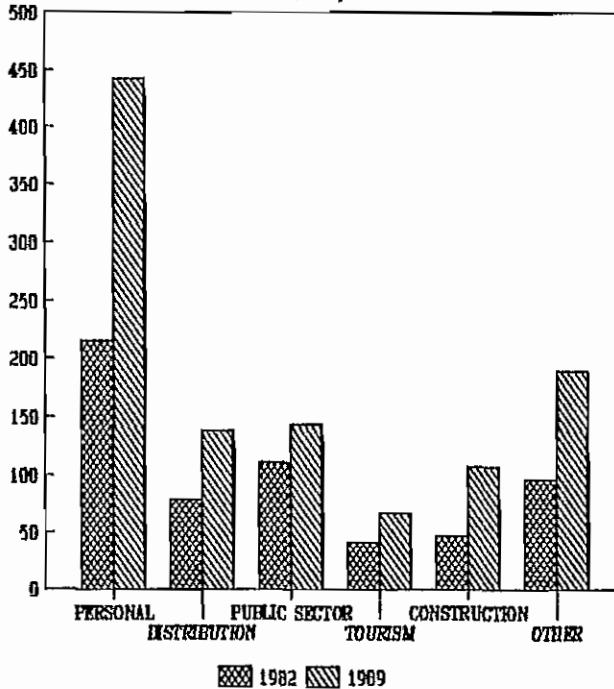
Personal credit recorded the most outstanding growth by far, increasing by \$226.8 million over the 1982-1989 period to \$442.1 million in 1989, which equates to an average annual growth rate

Chart 2

CONSUMER INSTALMENT CR O/S 1982 VS 1989
B\$ MILLIONS



TOTAL CREDIT OUTSTANDING 1982 VS 1989
ALL CURRENCIES B\$ MILLIONS



Source: The Central Bank of The Bahamas

of 11.2% as against 9.3% for all categories. Several wide fluctuations within the period, however, are obscured. In particular, of the total increase between 1982 and 1989, \$96.4 million or 43.5% was extended during 1987. The bulk of personal credit is advanced in local currency (98.8% in 1989). While foreign currency credit remained stable, Bahamian dollar loans grew from \$211.5 million (46.8% of total Bahamian dollar credit) in 1982 to \$436.8 million (49.2%) in 1989.

Looking at quarterly data, it is possible to distinguish different periods in the pattern of personal credit growth. The first period ranges from first quarter 1982 to end-1986 when personal credit accounted for a sizeable proportion of the increase in total credit. The second period, which comprises the period from first quarter 1987 through end-1989, highlights some discrete changes in credit and liquidity conditions. In particular, personal credit soared by 21.9% during the four quarters of 1987, facilitated by a build up of excess reserves (liquidity), which was augmented by a shift in the placement of funds by the National Insurance Board from the Central Bank to the commercial banks. In addition, the aggressive lending policies of a new entrant in the consumer loan market forced other banks to follow suit resulting in a less prudent lending environment in which unsecured lending was not uncommon.

The activities from first quarter 1988 to first quarter 1989 were characterized by a contraction in personal lending from

the unprecedented levels obtaining in the previous year. This marked a period of adjustment as banks utilized stricter criteria for loan qualification amid a tightening in liquidity conditions. As liquidity levels fell, banks experienced deficits on both primary and secondary reserve ratios necessitating borrowings from head offices as well as from the Central Bank.

There was a gradual recovery in personal credit during the last three quarters of 1989 when personal credit expanded by \$13.3 million. Trends in consumer lending are more clearly seen in the analysis of consumer instalment credit in Part II of the paper.

(B) Distribution

As in other Caribbean countries, the distribution sector receives a significant share of bank credit. In fact, it accounts for the second largest share of commercial bank credit. Credit more than doubled over the review period from \$78.6 million (13.3% of total credit) in 1982, to \$138.3 million (12.7%) in 1989. The majority of this lending was in the form of overdrafts, which represented about 50% of the total throughout the period. In dollar terms, growth in this sector has matched that of construction at \$59.7 million, placing it second along with the construction sector behind personal credit. This is indicative of The Bahamas' high marginal propensity to import, underscored by the lack of local production of both primary and

intermediate goods necessary as inputs for vital industries such as tourism and construction.

(C) Government and Public Corporations and Public Financial Institutions

The public sector (government and public corporations) borrows for two main reasons, namely for short-term working capital purposes and for financing of long-term capital development projects, and it absorbs a sizeable amount of local commercial bank credit--13.2% at end-1989. Government's short-term borrowings in the form of local currency overdraft facilities amounted to 56.8% of government's total commercial bank borrowing in 1989.

While total credit to government has fluctuated during the period, the amount outstanding increased by only \$11.5 million or 23.0% to \$61.4 million by 1989. A breakdown by currency shows Government's share of foreign currency credit outstanding falling from \$45.4 million (34.2% of total foreign currency credit) to \$15.7 million (7.9%). There was a simultaneous six-fold increase in its Bahamian dollar liabilities of \$29.6 million to \$45.7 million.

Foreign currency credit to the public corporations² which had declined to a mere \$3.8 million in 1985 accelerated to \$59.3 million or 29.9% of total foreign currency credit in 1989. This was predominantly due to borrowings by The Bahamas Hotel

Corporation for renovations to hotel properties. Bahamian dollar claims on this sector also fluctuated, falling until mid-1986 before rebounding by \$19.9 million to \$22.6 million in 1989. This was associated with the stepped-up capital development activities of the corporations and their concomitant need for working capital.

(D) Tourism

Total commercial bank credit to this sector increased at an average annual rate of 8.2% to \$67.2 million in 1989. Foreign currency credit accounts for a substantial proportion of overall loans and advances which have increased by \$26.2 million to register at \$67.2 million (6.2% of total credit) in 1989. This represents an average annual growth rate of 8.9%, which is significantly higher than the 6.2% registered for total foreign currency credit. By comparison, Bahamian dollar credit extended to this sector increased by \$8.3 million to \$21.2 million and represented a mere 2.4% of the total in 1989. It should be noted that commercial bank credit accounts for only a small share of total funds which flow into tourism, most of which is obtained from overseas sources.

(E) Construction

Credit for construction activities rose from \$47.2 million (8.0%) to \$107.0 million (9.9%) or at an average annual growth

rate of 13.9%. Tremendous growth was recorded in Bahamian dollar credit which expanded by \$41.3 million or 12.7% on an annual basis, with a rise in foreign currency credit by \$13.0 million or 27.7% annually.

Most of this growth took place in the midst of the tightened liquidity conditions prevailing since 1987, with credit outstanding doubling between 1986 and 1989. Commercial construction was notably strong during that period, partially due to the aforementioned construction of the two new shopping malls during 1987. While commercial loans outstanding totalled \$16.4 million or 34.7% of total construction credit in 1982, by 1986 this amount escalated to \$21.9 million (52.3%), and further to \$60.3 million (56.4%) in 1989.

(F) Agriculture and Fisheries

The agricultural sector in The Bahamas is still in the embryonic stage, hampered by structural and other rigidities in both the demand and supply activities of the market. The complexity of issues range from the hard, manual nature of the work which results in farming not being regarded as an occupation of choice; the historical, administrative/distributive problems; the lack of infrastructure to facilitate the movement of agricultural products to local consumers; and faulty pricing policies.

Despite the commonly perceived important role and scope for agricultural development in the advancement of economic diversi-

fication and import substitution activities, commercial bank credit extended to this area amounted to a conservative \$5.0 million or 0.5% of total bank credit in 1989. The absence of comprehensive data on this sector and the concomitant uncertainty have contributed to the perceived riskiness of agriculture as an area for investment. Commercial bankers have argued, perhaps reasonably so, that it is not their role to provide long-term development credit to risky areas and that they are not well suited to engage in such lending.

Fisheries has also been declared a high priority diversification target, but once again has been a low priority in terms of commercial bank lending. Credit increased only marginally from \$3.2 million in 1982 to \$5.5 million in 1989--approximately 0.5% of total bank credit.

(G) Manufacturing

A significant amount of credit is allocated for manufacturing activities. Credit in 1989 stood at \$48.7 million or 4.5% of total loans and advances in 1989. Bahamian dollar credit grew from \$13.4 million in 1982 to \$25.6 million in 1989 but retained its share of overall credit at 2.9%. Foreign currency credit, which commenced in 1985, climbed to \$23.0 million or 11.6% of total foreign currency credit by end-1989.

(H) Other Categories

The remaining six categories, mining and quarrying, entertainment and catering, transport, private financial institutions, professional and other services and miscellaneous collectively account for a very small fraction of total bank credit--11.9% in 1989.

PART II CONSUMER INSTALMENT CREDIT

Consumer instalment credit, which refers to loans for which repayments are on an instalment basis, consists mostly of personal loans. Data on this type of lending are disaggregated into 11 categories (see table 2).

Overall Trends

Total consumer instalment credit outstanding in 1982 amounted to \$112.4 million, which represented 24.9% of total commercial bank Bahamian dollar credit. This figure peaked at \$231.2 million in 1987 before receding to \$186.8 million in 1989.

Net credit (new credit less repayments) is examined in the analysis of consumer instalment credit as the net figure provides a better indicator than debt outstanding as to whether credit conditions are expansionary or otherwise. Looking at annual data on the value of net credit extended two main

TABLE 2

**CONSUMER INSTALMENT CREDIT OUTSTANDING
B\$000**

	1982		1983		1984		1985		1986		1987		1988		1989	
	Absolute	%	Absolute	%	Absolute	%	Absolute	%	Absolute	%	Absolute	%	Absolute	%	Absolute	%
PRIVATE CARS	41,320	36.8	51,906	43.2	64,691	46.3	80,053	49.6	83,227	44.1	81,199	35.1	61,450	31.9	49,251	26.4
TAXIS & RENTED CARS	481	0.4	957	0.8	954	0.7	539	0.3	589	0.3	382	0.2	425	0.2	365	0.2
COMMERCIAL VEHICLES	2,056	1.8	1,741	1.4	1,564	1.1	1,312	0.8	1,642	0.9	1,977	0.9	1,506	0.8	1,912	1.0
FURNISHINGS & DOMESTIC APPLIANCES	4,540	4.0	3,218	2.7	3,928	2.8	5,715	3.5	6,913	3.7	9,174	4.0	6,776	3.5	5,172	2.8
TRAVEL	3,012	2.7	1,912	1.6	2,762	2.0	2,816	1.7	3,700	2.0	5,192	2.2	3,211	1.7	3,203	1.7
EDUCATION	N/A	0.0	2,034	1.7	1,882	1.3	1,682	1.0	2,293	1.2	3,084	1.3	3,399	1.8	3,520	1.9
MEDICAL	N/A	0.0	1,687	1.4	1,659	1.2	1,743	1.1	2,503	1.3	3,609	1.6	3,437	1.8	3,652	2.0
HOME IMPROVEMENT	25,608	22.8	27,186	22.6	29,880	21.4	32,986	20.4	43,226	22.9	54,857	23.7	37,104	19.2	39,216	21.0
LAND PURCHASES	N/A	0.0	N/A	0.0	N/A	0.0	N/A	0.0	N/A	0.0	N/A	0.0	10,709	5.6	8,562	4.6
CONSOLIDATION OF DEBT	7,638	6.8	7,787	6.5	8,764	6.3	10,507	6.5	13,495	7.2	23,956	10.4	27,823	14.4	36,046	19.3
MISCELLANEOUS	27,779	24.7	21,750	18.1	23,615	16.9	24,093	14.9	30,976	16.4	47,758	20.7	36,983	19.2	35,858	19.2
TOTAL	112,434	100.0	120,178	100.0	139,699	100.0	161,446	100.0	188,564	100.0	231,188	100.0	192,823	100.0	186,757	100.0

Source: The Central Bank of The Bahamas

subperiods can be identified. The first is the period from 1982 to 1986, which was characterized by moderate expansion in net credit; net credit extended grew at a consistent average annual rate of \$6.5 million. This pattern became less distinct during the period 1987 to 1989 owing to marked changes in liquidity conditions.

During 1987, net instalment credit advanced by \$42.6 million, an increase of \$15.5 million (57.2%) over the increase 1986. During 1988, however, net credit was a negative \$38.4 million as new credit fell by \$88.5 million. Banks underwent a period of adjustment which was necessary to correct the excesses of the previous period. Moral suasion on the part of the Central Bank, the tightening liquidity situation, and defaulting statutory positions, were the primary forces behind this adjustment. In 1989 after most of the correction had been made, liquidity positions of the banks improved somewhat.

While the data available on overdue accounts with the commercial banks are not very detailed, they provide some indication of the increased difficulties in loan recovery and implications abound that certain banks made loans to higher risk borrowers. The only data available are the number and value of past due accounts. It is noteworthy that these figures only include unpaid principal (and not unpaid interest nor accounts which have been written off as bad debt). The actual overdue/ bad loans position, therefore, may be substantially larger than that reported here.

Based on quarterly averages, data for 1983 through 1986 show the average annual value of past due accounts outstanding to be \$4.3 million. The corresponding figure for the average number of accounts was 1,054. The average value climbed to \$5.7 million in 1987 and then to \$10.5 million in 1988, before falling back to \$8.9 million in 1989, as credit conditions eased and lending for consolidation of debt increased. The average number of past due accounts dropped in 1987 to 316 but increased almost six-fold to 1,850 in 1988 and further to 2,309 in 1989.

Composition of Instalment Credit

A noticeable trend has been the predominance of three categories of credit during recent years--lending for private car purchases, home improvement and consolidation of debt. Annual data indicate that these categories accounted for \$186.8 million, 66.7% of total instalment credit outstanding in 1989.

(i) Private Cars

Financing of private car purchases represented the largest use of instalment credit over the review period. The share of credit for this purpose expanded more quickly than overall credit, moving from 36.8% in 1982 to a peak of 50.4% in second quarter 1985. From third quarter 1985 to first quarter 1987, credit rose at a slower rate than the average, with the share in the total declining steadily to 26.4% in 1989. Most striking

was the decline in the share of private car lending in the credit mix from 49.6% 1985 to 26.4% in 1989. This may have resulted from a reclassification of a large amount of these loans under the debt consolidation category as growth in that area was substantial from 1987 onwards.

(ii) Home Improvement

Although home improvement credit fluctuated during the review period, the amount outstanding increased by \$11.7 million during 1987, peaking at \$54.9 million before receding to \$39.2 million at end-1988. This sector accounted for a significant portion of the surge in credit; in the latter half of 1987, outstanding debt rose sharply by \$8.2 million.

(iii) Consolidation of Debt

The sharp expansion in this category of lending is largely explained by banks' aggressive utilization of debt consolidation as a strategic means of gaining market share. From a quarterly average of \$9.5 million through to first quarter 1987, the outstanding balance for debt consolidation increased threefold to \$28.6 million in the interim period to end-1989. Net credit for debt consolidation represented \$13.0 million or 61.5% of the total extended during the second and third quarters of 1987. As a result, these loans increased from \$7.6 million or 6.8% of total instalment credit outstanding in 1982 to \$36.0 million

(19.3%) in 1989. The level of activity in this category of credit implies that there may have been a problem in loan repayments over and beyond that suggested by the amount of past due loans.

PART III MACROECONOMIC IMPACT OF DOMESTIC CREDIT EXPANSION

Background

In a small, open economy which maintains a fixed exchange rate, such as The Bahamas, credit control is pivotal to macroeconomic stability. The significance of this statement is underscored by the relationship between balance of payments deficits and the level of foreign exchange reserves in a model in which credit expansion fuels current account deficits.

The monetary approach to the balance of payments implies that an expansion in the domestic credit portion of the monetary base results in money market disequilibrium with an excess supply of money. Under a fixed exchange rate regime, this excess supply is exported and reflected in a balance of payments deficit financed via a drawdown on the foreign reserve portion of the monetary base. Once equilibrium has been restored, i.e. money demand and supply are again equal, the total money supply remains unchanged from the original quantity, as the only result is a switch in the monetary base towards higher domestic credit and a reduction in reserves. In other words, the increase in

credit is facilitated by an equivalent fall in external reserves, leaving money supply unchanged.

Other approaches to the balance of payments argue that the increase in money supply experienced with expanded domestic credit causes a rise in imports in response to higher aggregate demand which leads to a current account deficit. In the absence of offsetting capital inflows, this deficit is financed by a decline in the stock of foreign reserves.

In The Bahamas and in other Caribbean countries, there is a paucity of local production which means that much of the increase in consumption that occurs as a result of an increased money supply in fact takes place through higher imports. This creates a potential deficit on the current account which is facilitated by a drain on reserves.

Such a sequence was clearly evident in The Bahamas during the 1987 credit expansion. Commercial bank credit increased by \$164.5 million which was approximately equal to the cumulative increase between 1983 and 1986 of \$162.1 million. This occasioned a current account deficit of \$196.0 million which was 4.5 times that of the average of the preceding five years. The consequent erosion in external reserves was the largest ever experienced in one year at \$59.7 million. Furthermore, there was a capital account deficit of \$16.5 million during that year. While the expansion in credit exceeded the decline in reserves, the data suggest that there was a large under reporting of

inflows to offset most of this deficit--the net errors and omissions account recorded a \$152.7 million credit in 1987.

In previous years, during 1985 and 1986, for example, the banks had accumulated significant excess reserves while credit expansion was held at a relatively low level. The most satisfactory explanation for this revolves around risk aversion on the part of banks coupled with conservatism which led them to lend strictly to 'good' credit risks rather than bear exposure in risky loans. It can be argued that this aversion to risk was substantially reduced during 1987. In some periods there was an even slowdown in credit extension despite considerable liquidity in the system.

Monetary Policy Measures

The response of The Central Bank of The Bahamas to this massive credit expansion in 1987 was primarily traditional; moral suasion was employed in an attempt to contain credit expansion in the interest of protecting the foreign exchange reserves. Meanwhile, stabilization of interest rates was also a concern as liquidity conditions worsened. Liquidity dropped from a high of \$63.6 million in May of 1987 to \$17.2 million by December, or to a mere \$5.2 million when adjusted for borrowings from the Central Bank.

To discourage banks from using the Central Bank loans for credit expansion, the Bank rate was raised from 7.5% to 9.0% in

January 1988, and a ceiling was placed on all new bank deposits at 8.0%. The banking system struggled to maintain healthy liquidity ratios throughout 1988 and 1989 during which time the Central Bank became a lender of last resort on numerous occasions. This was especially the case in the latter half of the year when tourism inflows and deposit growth slowed. Despite Central Bank attempts to limit credit extension through moral suasion and the enforcement of liquidity requirements, commercial bank credit outstanding expanded by an additional \$171.0 million (18.7%) in the two years to 1989.

Associated with the credit surge in 1987 was a move by the National Insurance Board (NIB) in that year to increase the return on its investment portfolio by placing more deposits in the financial system and correspondingly reducing those held at the Central Bank. More specifically, deposits with the Central Bank, which had fluctuated but averaged \$24.6 million between 1984 and 1986, fell to \$0.2 million in 1987. Meanwhile, placements with financial institutions rose by \$44.8 million to total \$70.8 million in 1987 from a previous level of some \$26.0 million during 1984 through 1986. These deposits boosted excess reserves in the system and allowed banks to expand credit beyond levels which would have otherwise been possible. Placements of National Insurance deposits had previously been directed by the Bank as a potentially effective monetary policy tool. With liquidity condi-

tions remaining tight throughout 1988 and 1989, NIB deposits placed with financial institutions were only slowly withdrawn, declining by \$12.8 million in 1988 and by a further \$18.8 million in 1989.

Crowding Out

Apart from the deleterious effects on the balance of payments and foreign reserve holdings (which recovered by a mere \$1.5 million in 1988 only to fall by \$25.4 million in 1989) there was also substantial crowding out of the private sector. The rapid buildup of credit to the public sector coincided with a fall in credit to some of the more productive sectors. Between second quarter 1986 and end-1989, total commercial bank credit to the public sector was boosted by \$16.1 million to \$143.2 million. This represents an annual average increase of 58.6% which compares with a growth rate of 15.3% for total credit over the same period. Declines were posted for credit to the manufacturing and transport sectors in 1988 and for tourism in 1989. As previously noted, however, construction (especially commercial construction) was particularly buoyant during that period.

Summary

The events portrayed above indicate a clear link between credit expansion and reserve loss and a need for control over domestic credit by the monetary authorities. The strength of the relationship noted above would be a worthwhile topic for further research. The aim of monetary policy might be to limit domestic credit growth to some sustainable rate. This would be a rate which would provide for moderate growth in external reserves but would take into account the seasonality in foreign exchange receipts inherent in the economy. Thus, more than one rate might be appropriate depending upon the season and the ability of the Bank to smooth out changes in the deposit base due to fluctuations in inflows. Given the present difficulty in forecasting or even measuring foreign exchange inflows, the most practical method of determining the level of credit appropriate (given a reserve target) is to adjust credit in light of recent changes in the level of reserves.

The challenge is how to control credit in an open economy where control over the money supply is severely restricted. Open market type operations using treasury bills and registered stock have been used with some success to influence liquidity but are limited in scope due to ceilings on amounts which are allowed to be outstanding, the preference of banks to hold higher yielding loans, and most importantly the lack of a well developed capital market.

An effective means of influencing liquidity and hence credit in The Bahamas' case was the placement of NIB deposits by the Bank. Should the Bank resume this responsibility, the deposit base could be augmented in the latter half of the year and contracted in the first half in line with seasonal fluctuations of inflows.

Related to the control of overall credit is the concern over the distribution of credit and, in particular, the large proportion of credit allocated to the personal sector. These loans tend to be unproductive in that they do not increase the capital stock of the country nor its wealth, yet contribute to a substantial drain on external reserves. Indeed, it is generally acknowledged that for economic development to proceed, the share of investment in GNP must grow at a faster rate than the share of consumption. Such a trend is not reflected in the distribution of commercial bank credit during the period under review. From a macroeconomic point of view, it would be preferable to direct more credit towards productive sectors which would either increase export earnings or reduce import expenditures - that is, attempt to diversify the economy. This is a topic for further discussion outside the scope of this paper.

PART IV POLICY IMPLICATIONS

The developments in commercial bank credit over the period 1982-1989 suggest some important policy implications for authorities in The Bahamas. In an unprecedented experience, the year 1987 marked the first time that credit growth signalled alarms over the depletion of external reserves occasioned by the deterioration in the balance of payments. The experiences of other developing countries with balance of payments difficulties provide clear warnings as to the effects of excessively expansionary credit policies.³

Given the difficulty experienced in controlling credit to a level which did not pose a danger to the external reserves position in 1987, the consideration of additional monetary policy tools is warranted. Moral suasion has traditionally been the predominant tool supplemented by use of the Bank rate in directing interest rates and, for a time, placements of deposits by the NIB. A renewal of the practice of deposit placements by the Central Bank on behalf of the NIB would be a positive step, providing a direct avenue for influencing liquidity and hence credit conditions.

To control lending to the personal sector and overall credit expansion, selective credit controls (which have never been used in The Bahamas) should be considered. While this tool has been questioned on theoretical grounds over creation of distortions,

enforceability, and other points of debate, such controls might be effective in limiting credit booms or in directing more credit into productive areas. This tool has reportedly been effective in containing "undesirable bursts of spending" in Barbados during 1977-1982 (Worrel and Prescod, 1983). However, while selective credit controls might be a viable short-term solution, it is doubtful that they can be relied upon in the long term.

Credit ceilings, which allow for a certain rate of growth in credit or freeze credit to a certain specified level (and which may allow for different ceilings on different types of lending), have been used in other countries as part of their adjustment programs. It is preferable though to manage credit conditions using the tools available which change incentives rather than forcing certain specified limits on credit. Even so, such measures might be judged appropriate if other tools proved inadequate depending upon the situation.

As a more general comment, there is a need for more integration of monetary and fiscal policies. Since 1987 fiscal policy was highly expansionary with large public sector deficits accounting for a sizeable proportion of bank credit. A more sustainable pattern of growth demands prudent economic management.

Conclusion

During the decade of the 1980s, the Bahamian economy exhibited a measure of stability which inspired confidence in both locals and foreigners. While economic growth proceeded at a relatively favourable rate, the balance of payments remained manageable and fiscal and monetary and credit conditions followed a sustainable path. Thus the need for activist monetary policy measures was minimized. Events in 1987, however, conspired to introduce a larger degree of variability in credit conditions which impacted negatively on the balance of payments and foreign reserves position.

This episode clearly brought to light the need for the implementation of new monetary control instruments as traditional reliance upon moral suasion and the Bank rate proved to be ineffective. A list of suggested tools include a renewed practice of National Insurance Board (NIB) placements by the Central Bank, selective credit controls and credit ceilings. It has been argued that while measures which change incentives in order to alter behaviour are preferable, in the interest of protecting the foreign reserves position--which is critical to the smooth running of the economy on a longer-term horizon--imposition of other controls might become necessary depending upon the circumstance.

Several issues have not been sufficiently dealt with which relate to the topic in a less direct way. These include the

proposed deepening of the capital market in The Bahamas, which would enhance the effectiveness of some traditional monetary policy tools, and the execution of fiscal policy. As has been seen in similar economies, the fiscal sector cannot be artificially separated from the monetary sector and can significantly impact upon monetary and balance of payments conditions. These remain areas for further research.

ENDNOTES

- 1) The financial system is here defined as comprising the Central Bank, the commercial banks active in the local market (that is, excluding offshore banks), the other local financial institutions (OLFIs), and the Bahamas Development Bank. As at January 31, 1990, locally active commercial banks numbered nine and there were five locally active OLFIs. It is noted that insurance companies, the Bahamas Mortgage Corporation (BMC), and the credit unions could be included in a wider definition of the financial system.

- 2) The public corporations include The Bahamas Agricultural and Industrial Corporation (BAIC), Bahamasair, the Bahamas Broadcasting Corporation, the Bahamas Electricity Corporation (BEC), the Bahamas Hotel Corporation, the Bahamas Telecommunications Corporation (BATELCO), the Bahamas Water and Sewerage Corporation, and the National Insurance Board (NIB). The public financial institutions include the Bahamas Development Bank (BDB), the Bahamas Mortgage Corporation (BMC), and the Post Office Savings Bank (POSB).

- 3) Limitations on domestic credit expansion were reportedly at the heart of about one half of the seventy-nine stabilization

programs providing for IMF lending in the higher tranches between 1963 and 1972 which were examined by Reichmann and Stillson in their 1978 study.

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APPENDIX

This appendix contains descriptions of lending activities included under each category of credit, including the breakdown of consumer instalment credit.

Loans and Overdrafts Classified by Sector

1) Agriculture

Lending for livestock and dairy production, food crops, and for other agriculture. Any processing which might be done is included under manufacturing.

2) Fisheries

Loans and advances to firms engaged in commercial fishing, canning, preserving, or processing of the fish or other catch is included under manufacturing.

3) Mining and Quarrying

Credit to firms and individuals engaged in extracts from the earth of building and monumental stone, clays, sands, and gravels.

4) Manufacturing

Lending to individuals or businesses engaged in the physical or chemical transformation of inorganic or organic products into new products, either manually or mechanically. This includes the production of food and nonalcoholic beverages (e.g. bakery and dairy products, jams, soft drinks or fruit

juices, preparing or preserving of any animal products and canning and preserving any meat, fruit or vegetable); of alcoholic beverages and tobacco (e.g. rum, beer, wine, cigars, cigarettes); of building materials and metal products (e.g. production of iron or steel fixtures, cement, ceramics, and glass); of furniture and other wood products; of textiles, clothing and accessories; of petro-chemicals, chemicals and plastic products (e.g. manufacture of drugs and medicines, perfumeries and cosmetics, chemicals, fuels, plastics, paints, soaps and fertilizers); and other manufactures.

5) Distribution

Lending to companies or individuals engaged primarily in the import and export of goods by commission agents (firms which finance the purchase, shipping, insurance, freightage and storage of goods on consignment to wholesalers), by wholesalers, by retailers and by others.

6) Tourism

Lending to owners and operators of hotels, apartments, guest houses and other lodging places, whether the credit is for financing of construction, equipment, furniture or food. Restaurant facilities operated only in connection with provision of lodging are included here and not under entertainment and catering.

7) Entertainment and Catering

Credit to owners and operators of cinemas, night clubs, yacht and sporting clubs, amusement parks, professional musicians

and theatre groups, restaurateurs and other eating and drinking establishments, art galleries, museums, bowling clubs, and rental pleasure boats, cycles or horses.

8) Transport

Loans and advances to operators of bus and taxi services, trucking and removal companies, shipping and air freightage, and storage and warehousing.

9) Construction

Lending to special trade contractors primarily involved in contract construction. A construction operator may be engaged in building, altering, repairing, or demolishing roads, bridges, sewers, drains, harbours, airports, houses, factories, hotels, and etc. It also includes loans to land development for commercial, industrial or residential purposes and commercial construction of private, commercial and industrial structures.

10) Government

All lending granted directly to the central government.

11) Public Corporations

All lending to the public corporations.

12) Private Financial Institutions

Credit to all private financial institutions (such as trust companies, insurance companies, credit unions, etc.) except lending to other commercial banks and other local financial institutions (OLFIs).

13) Professional and Other Services

Lending to individuals or partnerships involved in law, accountancy, medicine, real estate, data processing, public relations, architecture and other services. Other services include businesses engaged in repairs, maintenance and cleaning, and nonprofit organizations.

14) Personal

Loans for housing for owner occupation (loans for housing which will be rented out is classified under residential construction), loans for land purchase for personal use, and other consumer credit--credit for consumer durables and nondurables.

15) Miscellaneous

Any lending which does not fit into any of the other categories.

CONSUMER INSTALMENT CREDIT CLASSIFIED BY SECTOR

Motor Vehicles (Items 1-3)

All loans to individuals for the purchase of private cars, taxis or rented cars, commercial vehicles, mortgages, etc. Lending to car dealers and any businesses dealing in the sale or resale of cars is excluded.

Furnishings and Domestic Appliances

Furnishings refers to draperies, curtains, carpets, chairs, tables, and similar household items. Domestic appliances are durable goods such as washing machines and dryers, refridgerators and freezers, radios, and television sets.

Travel

Loans to individuals to cover travel expenses whether for business or pleasure.

Education

Lending to individuals for the purpose of paying school fees and college tuition.

Medical

Loans to cover medical expenses such as doctor and dentist fees, hospital expenses, X-rays, medicine, etc.

Home Improvement

Credit with a maturity of up to five years made to individuals for the purchase of a house, or for repairs, extensions, modernization of houses, etc.

Land Purchase

Loans with a maturity of up to five years made to individuals for the purchase of property for personal use.

Debt Consolidation

Lending to an individual to enable incorporation of various debts into a single loan.

Miscellaneous

Any loans which do not fit under the above categories.