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Sharon Branch

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WTO, FTAA & CSME SERVICES LIBERALIZATION: IMPLICATIONS FOR MONETARY POLICY IN THE BAHAMAS

by Sharon G. Branch[1]

Abstract

The process of expanding trade liberalization has been well underway in the Caribbean since the imposition of IMF Structural Adjustment Programs and it has intensified with the coming into force of external trade arrangements such as the World Trade Organization (WTO)-led trade liberalization. However, as a result of tremendous growth in the services sector over the years, the focus shifted towards the liberalization of services, geared to the elimination of almost all restrictions on internationally-traded services. Hence, the WTO introduced the General Agreement on Trade in Services (GATS), the first set of multilateral rules governing international trade in services. Subsequently, when Free Trade Areas of Americas (FTAA) negotiations, aimed at fostering deeper cooperation in trade in goods and services were launched, the guidelines issued under GATS were endorsed as the rules to follow. The Caribbean response to these global challenges has been to deepen the integration process, thus birthing of the decision to establish the Caricom Single Market and Economy (CSME).

Who may actually benefit from the expanding cobweb of agreements and how specific services agreements might change the status quo of specific countries are interesting issues that need to be addressed. Countries cannot evade the fact that their macroeconomic policies will be impacted by the various trades in goods and services agreements. Changes in the conduct of both fiscal and monetary policies will reflect the consequences of trade and services liberalization. Hence, this paper focuses on WTO, FTAA and CSME services liberalization provisions and their effect on monetary policy in The Bahamas given the peculiar nature of the Bahamian economy.

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[1] The views expressed in this paper are those of the author and do not necessarily represent the Central Bank of The Bahamas. The paper should be considered a work in progress and as such the author would welcome any comments on the written text or any of the issues cited. The author would also like to thank all staff of the Research Department, especially John Rolle, Gabriella Fraser, Elvan Morris, Peggy Winder, Jamell Bodie and Cherran Weech-O'Brian for their valuable assistance.

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Section 1: Introduction and Literature Review

International trade has been growing in importance globally and for the Caribbean. The integration of the world economy over the past two decades has been dramatic with the development of various free trade areas. All Caribbean economies are highly dependent on foreign trade with the developed world, thus influencing the character of the growth process in their economies. These countries' ability to chart their own economic and social destiny is significantly affected by their degree of dependence on the developed world and other external forces.

The current form of globalization, free trade areas (FTAs) are coming under much scrutiny. There is a deep and abiding concern with global international relations as modern transport and communications are rapidly shrinking the world into what Todaro (1997) referred to as, a "global village." Global trade has been greatly facilitated by improvements in transportation and communications technologies, general declines in tariffs and continuing peaceful relations among major industrial countries. As a result, free trade areas have grown in importance, with the move towards the elimination of restrictions and artificial impediments to foreign trade and capital flows being the main focus.

The case for free trade is premised on the argument that, through trade based on the principle of comparative advantage, the world economy can achieve a more efficient allocation of resources and a higher level of material well-being than without free trade. However, there are conflicting views concerning the pros and cons of such trade. Some theorists have argued that free trade promotes competition and deters monopoly. According to McConnell (1998) the increased competition from foreign firms forces domestic firms to find and use the lowest-cost production techniques. In addition, it compels them to be innovative with respect to both product quality and production methods, thereby contributing to economic growth.

However, Hufbauer and Schott (1992) posit that free trade areas result in freer trade and not free trade, since not all trade barriers are subject to elimination (e.g. selected tariffs and subsidies). Further, they state that free trade areas serve as an insurance policy against sudden changes in trade policies that may lead to increased discrimination against trading interests of the partner countries. Furthermore, they believe that there is little precedent for a FTA between developed and developing countries since most FTAs have been between countries at similar levels of economic development (CARICOM, for example).

Several literatures also state that liberalization policies are themselves misconceived and not really relevant for developing countries at even the theoretical level. Given the institutional and structural characteristics of developing countries (small and open economies), the theory is that opening up is destined to fail. Some theorists argue that it is not liberalization policies, per se, that they condemn, but the implementation of these policies that are at fault. Some proponents, while tending to accept the neoclassical premise that liberalization has long-run advantages, are critical of how the policies are executed.

The study of Addison and Demery (1989) on the impact of liberalization on growth and equity emphasize the need for careful co-ordination with exchange rate and monetary policy. They argue that failed liberalization attempts can be attributed to inappropriate macroeconomic policies.

According to Eichengreen and Taylor (2003), regional trade agreements (RTAs) can have different consequences for monetary institutions and exchange rate arrangements depending on the context and circumstances in which they are established. They pointed out that political and economic integration motivated the European Union. In Europe, economic and monetary integration was envisaged from the start as part of the process of building an "even closer Europe", entailing a single market and the creation of supra-national policy making institutions, in addition to a customs union and closer coordination of national policies. Thus, politics shaped the monetary consequences of

Europe's single market by opening up institution-building options that are not obviously available in other regions, while commercial integration led to a sharp expansion in the volume of trade.

Eichengreen and Taylor (2003) postulate that North America contrasted with Europe in that there was little desire for political integration in North America, because the three nations participating in the North America Free Trade Agreement (NAFTA) were jealous of their sovereignties. Hence, there was little willingness to contemplate a single currency for NAFTA, given that the monetary authority charged with its management would not have been regarded as politically legitimate, given the lack of accountability. This study concludes that the best that can be hoped for in the short-run is better individually-managed monetary policies that credibly deliver improved exchange rate stability. be it by inflation targeting or other means.

Thus, with the spirit of free trade overtaking world economies, it has produced a confusing patchwork of hemispheric free trade agreements. Currently, Western Hemisphere countries have either signed or are negotiating over fifty (50) sub-regional trade pacts. Looming over all these efforts is the promise of creating by 2005 the Free Trade Areas of the Americas (FTAA).

These developments place the Caribbean trade policy squarely at the crossroads of whether or how to proceed formally with the changes in the global economy. Consequently, it was decided that a united Caribbean Community is needed since deepening the integration process by systematically removing barriers/tariffs and restrictions and coordinating economic policies is necessary for coping with the global challenge, than member states acting individually. This decision gave birth to the establishment of the Caricom Single Market and Economy (CSME).

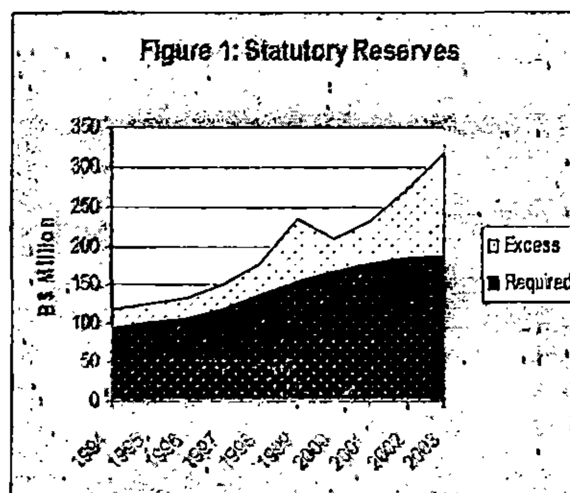
Note that, the establishment of all these international trade agreements highlighted the need for liberalizing trade in services in all participating countries, since barriers such as qualification requirements and procedures, technical standards and licensing

requirements and cross-subsidization exist. The move towards the liberalization of services will impact how monetary policy is conducted in these countries. Consequently, this paper seeks to explore the implications of services liberalization on monetary policy in The Bahamas.

The remainder of this paper is organized as follows. Section 2 gives an overview of the Bahamian economy, while section 3 examines issues pertaining to the design and conduct of monetary policy, focusing on monetary policy in The Bahamas. Section 4 explores the development of free trade areas looking at the structure, process and rules governing current negotiations. Section 5 focuses on the implications of trade in services liberalization on monetary policy in The Bahamas, citing the challenges ahead. The paper concludes with some recommendations and general findings in Section 6.

Section 2: OVERVIEW OF THE BAHAMIAN ECONOMY

The Bahamas for the past decade has been experiencing economic stability despite some economic challenges. For instance, there was a slowing in the domestic economy following the September 11, 2001 unprecedented attack on the United States, which had adverse implications for tourism output. Nevertheless, for a number of years the economy has manifested positive growth rate and low inflation. For the Bahamian economy, tourism is the principal economic activity contributing approximately 40.0% of GDP, followed by the international financial services which add some 15.0% to GDP. The remaining 45.0% of total GDP is linked to Government, construction, agriculture, manufacturing and other.



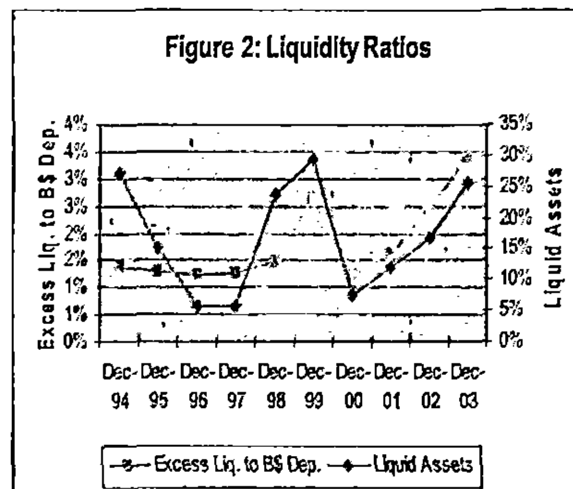
In 2003, The Bahamas accomplished a per capita income of approximately B$16,400, with total nominal GDP amounting to B$5.2 billion. For the past decade,

economic growth has been consistent, with the economy growing at an average annual rate of 2.4% between 1994 and 2003.

Moreover, on the fiscal side, the current revenue as a percentage of GDP remained strong even though it showed a decline to 17.4% in 2003 from 20.1% in 1994. Conversely, for the decade, the current expenditure as a percentage of GDP increased to 19.2% in 2003 from 18.1% in 1994. Accordingly, external financing as percentage of GDP expanded from 0.5% in 1994 to 4.0% in 2003, while internal financing decreased to 3.3% in 2003 from 3.9% in 1994.

Over the past decade, gross international reserves which averaged B$298.2 million, more than doubled, increasing from $173.6 million in 1994 to $484.1 million in 2003 (see Table 1). Complementing this result was the import cover ratio, which averaged 16.6 weeks of imports in 2003 up from 9.8 weeks in 1994.

Excess reserves also had continuous growth, increasing to $128.9 million at the end of 2003 from $26.1 million in 1994 (see Figure 1).Excess reserves to Bahamian dollar deposits, which stood at 1.4% of deposit liabilities at end-December 1994, rose to approximately 3.4% of deposit liabilities at end-December 2003. However, excess liquid assets ratio which was 27.1% above the statutory minimum required level at the end of 1994, decreased marginally to 25.5% of deposit liabilities at end-December 2003 (see Figure 2).



In 1999, both excess reserves and excess liquid assets ratios peaked at 3.0% and 29.3% respectively. This was as a result of sustained growth in external reserves and buoyancy in bank liquidity, which permitted a reduction in the Central Bank discount rate.

Historically, since 1974, the national currency, the Bahamian dollar has been pegged to the United States at par. The peg has served the economy well with the inflation averaging 1.7% over the past decade, thus The Bahamas is considered a "low" inflation economy. Favourable results were also recorded for unemployment as the rate fell from 13.3% in 1994 to 10.8% in 2003 (see Table 1).

Section 3: Issues in the Design and Conduct of Monetary Policy

3.1: Objectives, Targets and Monetary Policy Instruments used in The Caribbean

Monetary policy is a powerful tool, and sometimes may have unexpected and unwanted consequences. It can be defined as a collection of decisions that are formulated and implemented by monetary authorities (Central Banks) in their various fields of operations which are aimed at achieving certain ultimate objectives with regards to the country's economy.

Traditionally, monetary policy objectives include price stability, promoting growth, achieving full employment, smoothing the business cycle, preventing financial crises and stabilizing long-term interest rates and real exchange rates. However, for the Caribbean economies, the objectives of monetary policy have been focused on maintenance of adequate foreign exchange reserves and price stability.

Moreover, monetary policy targets are classified as either intermediate or operating targets. Intermediate targets refer to variables that affect the ultimate objectives of monetary policy, but are not controlled directly by the central bank. Included are various monetary aggregates and long-term interest rates. Conversely, operating targets are tactical goals that the central bank can influence better in the short run. Although central banks cannot use monetary policy instruments directly to affect intermediate targets, they can use them to affect operating targets, such as reserve money and short-term interest rates, which in turn influence movements in intermediate variables.

TALBE 1: SELECTED MACROECONOMIC IINDICATORS FOR THE BAHAMAS (1994-2003)										
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Nominal GDP (B$ Mn.)	3,053	3,069	3,742	3,940	4,190	4,573	4,920	4,917	5,058	5,187
Real GDP (1991 Prices) (B$ Mn.)	2,717	2,746	3,205	2,785	2,848	3,189	3,348	3,280	3,303	3,333
Per Capita Income (B$)	11,184	11,041	13,130	13,640	14,267	15,325	16,205	15,918	16,218	16,400
Inflation Rate (%)	1.3	2.1	1.4	0.5	1.3	1.3	1.6	2.0	2.2	3.0
Unemployment Rate (%)	13.3	10.9	11.5	9.8	7.7	7.8	n.a.*	6.9	9.1	10.8
Current Account Balance (B$ Mn.)	63.0	60.9	35.7	29.2	36.5	80.4	118.4	57.1	-29.8	-93.2
Overall Balance (B$ Mn.)	10.1	-1.2	-33.9	-100.4	-45.0	-16.1	19.5	-35.7	-129.3	-165.9
Current Revenue (B$ Mn.)	614.6	647.1	685.9	728.2	760.9	868.8	937.2	920.2	888.9	901.8
Capital Revenue (B$ Mn.)	0.0	9.0	0.0	0.8	0.5	0.3	0.0	0.1	0.0	0.0
Current Expenditure (B$ Mn.)	551.6	586.2	650.2	699.0	724.4	788.4	818.8	863.1	918.7	995.0
Capital Expenditure (B$ Mn.)	52.9	71.1	69.6	130.4	82.0	96.8	98.9	92.9	99.5	72.7
Internal Finance (B$ Mn.)	120.	80.6	131.5	191.2	107.0	124.7	55.8	150.2	322.2	170.1
External Finance (B$ Mn.)	14.1	6.8	7.8	53.9	6.4	23.5	14.7	15.7	11.6	205.0
Prime Lending Rate (%)	6.75	6.75	6.75	6.75	6.75	6.00	6.00	6.00	6.00	6.00
Gross Reserves (B$ Mn.)	173.6	170.6	163.0	219.5	338.8	404.0	342.6	312.4	373.2	484.1
Import Cover Ratio (wks)	9.8	9.1	7.9	9.2	12.2	13.3	10.5	9.7	12.0	16.6
* Year of census										
Source: The Central Bank of The Bahamas										

Monetary instruments that affect operating targets are generally classified as either direct or indirect measures. Direct policy instruments refer to those measures used by the central bank to attain the aims of monetary policy by means of certain rules prescribing the behaviour pattern of banks and possibly other financial institutions. It refers to the one-to-one correspondence between the instrument and the policy objective. Examples are administratively set interest rate ceilings, individual bank credit ceilings, changes in reserve requirements and directed lending (lending at the request of the authorities, rather than for commercial reasons).

A widely used direct policy instrument in the Caribbean is reserve requirements. The practice of requiring the commercial banks to keep a certain percentage of their deposits, either in till/cash and or deposit with the central bank, has been a feature in the financial arrangements of English speaking Caribbean countries. Reserve requirements allow commercial banks to hold a specified part of their portfolios in reserve accounts at the central bank. Such reserve requirements can be used to ensure the liquidity or solvency of the banking system and also they can be transformed into an important instrument for the control of bank credit and hence, money supply, by limiting the extent to which loans and investments can be increased or decreased as a result of changes in cash resource.

Credit ceiling is another direct instrument of monetary control that is still used by a few Caribbean countries. A credit ceiling is the maximum allowed percentage increase of the stock of pre-specified types of bank assets over a given time period. Its value is normally set in reference to the stock of the regulated assets at the end of some base period.

price of bank reserves as the central bank engages in transactions with both financial and non-financial institutions. Market participants are encouraged to take specific actions regarding their lending and borrowing behaviour, resulting in price and interest rate incentives or disincentives in the financial markets. These incentives or disincentives arise out of technical intervention by the Central Bank in the various financial markets involving the buying and selling of specified financial claims such as government stocks, Treasury bills, bankers' acceptances and foreign exchange in order to influence prices and therefore, interest rates and exchange rates. The main types of indirect instruments are open market operations that are used to inject and absorb liquidity and the central bank lending facility.

One kind of indirect instrument used in the Caribbean is open market operations, which are broadly defined as the purchase or sale of financial instruments by the central banks, in either the primary market or the secondary market. Open market operations, involving the purchase of securities by the central bank, are usually undertaken for the specific purpose of injecting cash reserves into the domestic banking system, while open market sales withdraws cash reserves from the banking system. Instruments commonly used for this purpose include treasury bills, central bank bills or prime commercial paper.

Central bank lending facility (discount rate) is another indirect instrument used in the Caribbean. The discount rate refers to the rate at which the central bank is prepared to make credit available to the commercial banks through discounts and advances. A change in this rate signals the need for a change in the whole spectrum of short-term money market rates, which is expected to affect the total volume of credit and ultimately

low and they are attractive to governments that want to channel credit to meet specific objectives. On the other hand, indirect instruments encourage intermediation through the formal financial sector, while at the same time permitting the authorities to have greater flexibility in policy implementation.

3.2: Monetary Policy Under Fixed Exchange Rate Regime

Developing countries face an economic environment undergoing significant changes that have important implications for their choice of exchange rate arrangements. For many small open economies, such as the Caribbean, the choice of exchange rate regime is the fundamental macroeconomic policy choice. Hence, some developing economies pegged their exchange rates so as to provide a useful and credible nominal anchor for monetary policy and to avoid many of the complexities and institutional requirements for establishing an alternative anchor, such as a functional and credible inflation target backed by an operationally independent Central Bank.

Under a fixed exchange rate regime, a country specifies its currency in a fixed relationship to some currency of its choice (the United States dollar, the pound sterling, etc.) and alters same only as a matter of deliberate economic policy. The exchange rate determines how monetary policy is implemented in any country.

Shambaugh (2003) studies the relationship between fixed exchange rate and monetary policy, focusing on how a pegged country's interest rate responds to changes in the base country interest rate. He finds that countries with fixed exchange rates do in fact follow the interest rate of the base country more closely than countries with flexible exchange

respond to shocks. For example, a country trying to maintain a fixed rate may not be allowed to increase its borrowing through the bond market because this might affect interest rates, putting pressure on the exchange rate peg.

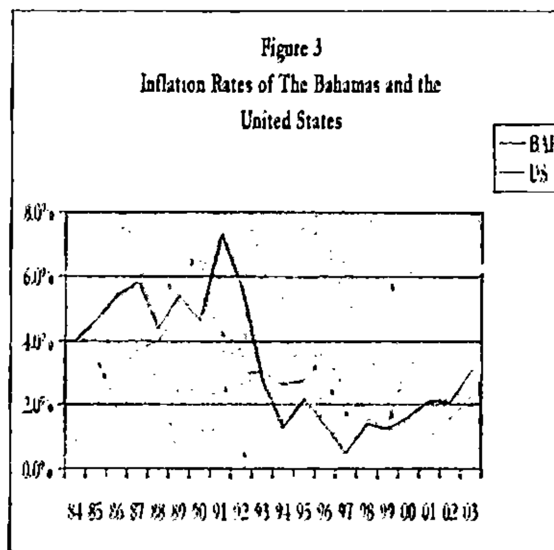
Under a more flexible arrangement monetary policy may be more independent, however, inflation is likely to be higher and more variable. Evidence of this was seen within the Caribbean Community, where there exist two kinds of foreign exchange rate regimes. The countries with fixed regimes, The Bahamas, Barbados, Belize, Suriname and members of the Eastern Caribbean Currency Union, generally experience low inflation. For those with flexible regimes, Guyana, Jamaica and Suriname, excluding Trinidad & Tobago whose system is similar to that of fixed regime, inflation rates are comparatively higher (See Table 2).

Table 2: Caribbean Community Average Annual Inflation Rate (%)

	1995	1996	1997	1998	1999	2000	2001	2002
Bahamas	2.2	1.4	0.5	1.4	1.3	1.6	2.1	2.1
Barbados	1.9	2.4	7.7	-1.3	1.6	2.4	2.6	1.4
Belize	2.9	6.4	1.0	-0.9	-1.2	0.6	1.1	2.2
EC Currency Union	3.5	2.2	3.0	2.6	1.9	1.9	2.0	1.0
Guyana	8.1	4.5	4.1	4.7	8.7	6.2	2.6	8.3
Jamaica	25.6	15.8	9.2	7.9	6.8	6.1	8.8	7.3
Suriname	235.8	-1.0	7.2	19.0	98.8	59.3	38.6	n.a.
Trinidad & Tobago	5.3	3.3	3.7	5.6	3.4	3.6	5.5	4.2

Source: The Central Banks Annual and Statistical Reports

Overall, whatever exchange rate regime a country pursues, long-term success depends on a commitment to sound economic fundamentals and a strong banking system.



3.3: Monetary Policy in The Bahamas

Monetary policy in The Bahamas is centralized under The Central Bank of Bahamas. The Bahamas adopted a fixed exchange rate regime in 1973, with the Bahamian dollar fixed at a parity of one to one against the United States dollar (BS$1=US$1). Consequently, the primary objective of monetary policy in The Bahamas has always been to maintain stable credit and other conditions to support the fixed parity between The Bahamian and United States dollar, while at the same time providing some degree of certainty to the economic policy environment.

Further, The Bahamas has in place, exchange control regulations, which restricts capital mobility, while at the same time creating the environment for monetary policy to be executed. Under the Exchange Control Act, 1952 and the Exchange Control Regulations, 1965, the Central Bank administers exchange controls and delegates to authorized dealers, the authority to approve allocations of foreign exchange for certain current

Table 3: The Bahamas – Central Bank Net Domestic Assets (1994-2003)										
B$ Millions										
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
External Reserves	**173.6**	**170.6**	**163.0**	**219.5**	**338.8**	**404.0**	**342.6**	**312.4**	**373.2**	**484.1**
Monetary Base	**223.5**	**232.0**	**227.2**	**257.2**	**310.2**	**373.5**	**360.8**	**407.3**	**451.5**	**484.4**
Currency in Circulation	124.0	129.9	143.5	157.3	173.3	223.2	216.0	218.6	221.3	239.9
Bankers Balances	99.5	102.0	83.7	99.9	136.9	150.3	144.8	188.7	230.2	244.5
Net Domestic Assets/Liabilities	**49.9**	**61.4**	**64.2**	**37.7**	**(28.6)**	**(30.5)**	**18.2**	**94.9**	**78.3**	**0.3**
Net Credit to Government	**130.4**	**142.3**	**146.3**	**125.9**	**59.3**	**69.8**	**120.7**	**187.4**	**172.9**	**108.4**
Advances	44.0	47.0	52.0	50.0	53.5	53.5	53.5	56.9	71.8	71.0
Registered Stocks	34.8	28.3	20.9	10.8	8.4	5.6	8.9	34.0	38.6	43.8
T-Bills	64.8	74.1	80.3	80.4	0.0	13.9	66.2	98.8	72.0	0.0
Less: Deposits	13.2	7.1	6.9	15.3	2.6	3.2	7.8	2.3	9.5	6.4
Net Credit to Public Corporations	**(4.0)**	**(1.3)**	**(0.3)**	**(3.1)**	**(1.3)**	**(9.5)**	**(6.5)**	**(2.3)**	**(2.4)**	**(14.4)**
Claims on Banks	**0.0**	**0.0**	**0.0**	**0.3**	**0.3**	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**
Other Items (Net)	**(76.5)**	**(79.6)**	**(81.8)**	**(85.4)**	**(86.9)**	**(91.0)**	**(96.0)**	**(90.2)**	**(92.2)**	**(93.7)**

Source: The Central Bank of The Bahamas

As a result of this policy stance, the Central Bank has always used a combination of direct and indirect instruments in implementing monetary policy. The main instruments of monetary policy in The Bahamas are reserve requirements, changes in the Bank discount rate and selective credit controls, supplemented by moral suasion. As a consequence, the external value of the Bahamian dollar has remained at the same level for almost three decades.

Reserve requirement, a direct monetary instrument, plays a vital role in implementing monetary policy in The Bahamas. One of the first acts of the Central Bank in 1974 was to impose legal reserves on banks operating domestically. Under the statutory reserve requirement, banks are obliged to keep reserves equal to 5.0% of total Bahamian dollar deposits. The Act authorizes the Central Bank to vary this ratio between 5.0% and 20.0%, but it has remained unchanged at 5.0% since instituted in June 1974.

Table 4: Bank Liquidity

Period	RR	% Share ER/RR	MRLA	% Share NELA/MRLA
1994	93,407	27.9	307,241	27.1
1995	100,198	26.5	331,022	15.0
1996	106,714	24.8	354,887	5.6
1997	119,272	25.6	393,360	5.7
1998	135,500	30.4	452,785	23.6
1999	153,890	52.6	507,931	29.3
2000	166,600	25.0	539,047	7.4
2001	176,098	32.1	569,319	11.8
2002	183,435	48.5	589,914	16.6
2003	187,218	68.9	615,615	25.5

RR= Required Reserves; ER = Excess Reserves; MRLA = Minimum Required Liquid Assets; NEAL = Net Eligible Liquid Assets

Following an amendment to the Central Bank Act in August 1990, the central bank strengthened the enforceability of reserve requirements by increasing the penalties that could be applied for shortfalls in banks' required reserves. The penalty was set at a maximum of twice the discount rate prevailing at the time of the deficiency for every day that the deficiency persisted. Fines for incurring the secondary reserves deficit were set at these same levels. As of January 1991, the actual fine imposed amounted to one tenth of 1.0% (0.1%) of the amount of the deficiency for each day the deficiency continued.

Moreover, in order to restrict consumer credit growth which caused undue pressure on the external reserves and resulted in a sharp decline, in November 1990, the central bank instructed the commercial banks to insist upon a minimum 35.0% down payment (equity) requirement on consumer loans. It was not until January 1993, that the decision was made to rescind the 35% borrowers' equity on consumer loans, with banks returning to the 25% norm. In May of 1998, such measures were required again to curtail the accelerating trend in consumer credit growth, hence the Central Bank instructed financial institutions to insist on a 25.0% down payment or equity requirement on new consumer loans. Given improved bank liquidity and external reserves (See Tables 3 & 4), in January 1999, the Central Bank lifted the 25.0% down payment requirement for new consumer loans and subsequently reduced the requirement to a low of 10.0%.

The Central Bank also introduced interest rate controls in May 1975 to aid in the management of financial sector liquidity. In 1975, excess liquidity in the system led the Bank to establish a Special Deposit Account, on which interest of 4% was paid on bank balances in excess of 250% of the statutory level. The scheme was in existence until

from 0.5% to 1.0% above the prime rate (9.0%). One year later, November 1980, in an attempt to discourage commercial banks from availing themselves of the Bank's accommodation in the wake of strong private sector demand and falling liquidity, the Central Bank imposed a surcharge of 2.0% on loans to banks, hence raising the cost of borrowing from the Central Bank to 13.0%. The surcharge was lifted one year later, November 1981, when the Central Bank made a decision to remove the 2.0% surcharge on frequent borrowing by commercial banks. However, in January 1982 as part of the Central Bank's credit restraint policy, the 2.0% surcharge on frequent borrowing by commercial banks was reintroduced. During this period the effective bank rate was increased to 12.0%, with the actual rate charged fluctuating between 10.0% and 12.0%.

Further, in a move to avoid the excessive upward pressures on lending rates and the bidding up of deposit rates among banks, the Central Bank in 1988 imposed an interest rate ceiling of 8.0% on all new deposits accepted by banks. The ceiling on deposit rates was lowered to 7.0% in 1992 and to 6.75% in 1993, before being abolished in 1994.

Imperative to note is that, the Central Bank affects interest rates by varying the Bank discount rate, which is used mainly to signal changes in monetary policy. Hence, in April 1983, in an effort to stem the upward pressure on interest rates, while maintaining rates at existing levels, the central bank decided to lower its discount (bank) rate to 9.0% from 11.0% and it remained unchanged until 1992. The discount rate was reduced in 1992 to 7.5%, in keeping with international interest rates and weakness in the domestic economy, and by 50 basis points to 7.0% in 1993. In 1994, a further reduction of 50 basis point to 6.5% occurred, while the last reduction in the discount rate was in 1999, when the Central

commercial bank credit to the private sector. The credit freeze became necessary as increased foreign currency demand pressures, emanated from B$ credit expansion, leading to external reserves being depleted (See Table 3). Hence, the Central Bank instructed the banks to provide new credit only to the extent of resources provided from ongoing repayments, but was free to determine how such resources would be allocated within their portfolios.

The credit ceiling was in place for over two years and was lifted recently, in August 2004, as a result of improved economic conditions in The Bahamas and a rebound in tourism and foreign investment activities. However, it is still a requirement by the Central Bank that, banks limit the existing or resulting total debt service ratio on the aggregate of personal loans, mortgages, rent and property maintenance to 40%-45% of ordinary monthly income and require a minimum contribution of 15% on all personal loans, with the exception of those secured with mortgage indemnity insurance.

Section 4: Development of Free Trade Areas (WTO, FTAA, CSME)

4.1: Background

Under the banner of trade liberalization a number of trade agreements have been established. Beginning in 1948 the General Agreement on Tariffs and Trade (GATT) came into being but was succeeded by The World Trade Organization (WTO), which was officially established in 1995. The WTO was essentially an extension of GATT, with General Agreement in Services (GATS) and the agreements on Trade Related Aspects of Intellectual Property Rights (TRIPS) being two other major trade agreements added.

Table 5: The Bahamas – Financial Survey (1994-2003) BS Millions										
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Net Foreign Assets	**(56.2)**	**(78.1)**	**(108.6)**	**(113.4)**	**(24.0)**	**(50.5)**	**(83.7)**	**(234.5)**	**(357.3)**	**(144.0)**
Total Domestic Credit	**2,356.2**	**2,572.5**	**2,776.7**	**3,059.3**	**3,425.7**	**3,823.5**	**4,270.4**	**4,676.9**	**4,940.4**	**4,974.0**
Government (Net)	412.5	424.1	422.1	419.8	452.6	495.5	508.5	626.0	651.4	506.5
Private Sector	1,859.2	2,060.1	2,263.9	2,551.0	2,2836.7	3,155.1	3,618.6	3,902.1	4,069.6	4,094.6
Public Corporations	84.5	88.3	90.7	88.5	136.4	172.9	143.3	148.8	219.4	372.9
Money Supply										
Currency in Circulation	88.5	91.6	96.2	109.7	125.6	148.4	151.4	153.5	154.8	160.1
Demand Deposits	323.8	351.5	349.6	409.1	470.8	609.8	652.3	623.2	662.9	747.3
M1	**412.3**	**443.1**	**445.8**	**518.8**	**596.4**	**758.2**	**803.7**	**776.7**	**817.7**	**907.4**
Savings Deposits	338.9	342.0	355.1	392.9	437.9	548.0	596.1	604.6	630.7	678.8
Fixed Deposits	1,211.1	1,317.8	1,427.1	1,554.4	1,809.2	1,888.5	2,063.7	2,244.0	2,296.2	2,315.9
M2	**1,962.3**	**2,102.8**	**2,228.0**	**2,466.1**	**2,843.5**	**3,194.7**	**3,463.6**	**3,625.3**	**3,744.6**	**3,902.0**
Resident F/C Deposits	26.3	33.5	28.8	41.5	60.7	53.0	86.3	91.8	91.6	101.3
M3	**1,988.6**	**2,136.3**	**2,256.8**	**2,507.6**	**2,904.2**	**3,247.6**	**3,549.9**	**3,717.1**	**3,836.2**	**4,003.3**

Source: The Central Bank of The Bahamas

The whole rational of WTO policy is based on the theory of comparative advantage, which avows that individuals will all be better off, materially, if they each produce that good at which they are relatively most efficient in producing and obtaining other goods by exchanging with others. Likewise. countries are supposed to become better off by removing protection from local inefficient industries, producing only those goods which they do produce relatively efficiently and then exchange them for those goods that others produce efficiently.

As a result of this assertion, WTO[2] operates under three (3) basic principles. One is trade without discrimination, whereby all non-tariff restrictions, such as import quotas and export subsidies, have been outlawed. In some exceptional cases, tariffs are permitted but they must be applied at the same rate for each good across all countries, once goods enter a country they must not face discriminatory treatment from locally-produced goods and negotiated tariff reductions between countries must be extended to all. The second principle deals with the predictable and growing access to markets, where countries are given more secure and predictable markets for their exports with the removal of non-tariff barriers and the requirement that an existing tariff level for any product cannot be increased without compensation to major trading partners. The final principle relates to encouraging economic development and economic reform and as such the WTO's agenda is to get countries to acknowledge that open market policies are in their best interest.

Therefore, at the heart of WTO is the concept that all participants should be treated in a non-discriminatory fashion with respect to tariffs and other barriers to trade, which is referred to as the most-favoured-nation principle, where all participating members are

The objectives of this agreement are, "trade liberalization with a view to generate economic growth and prosperity, contributing to the expansion of world trade; to generate increasing levels of trade in goods and services, and investment by means of market liberalization, through fair, transparent, predictable and coherent policies and with no counter-effect on free trade rules; to enhance competition and improve market access conditions for goods and services among the Parties, including the area of government procurement; to eliminate barriers, restrictions and/or unnecessary distortions to free trade among the Parties, including unfair trade practices, para-tariff measures, unjustified restrictions, domestic subsidies and aids to trade in goods and services; to eliminate the barriers to the movement of capital and business persons among the Parties; to foster the development of a hemispheric infrastructure that facilitates the circulation of goods and services and investment; and to establish mechanisms that guarantee greater access to technology, through economic cooperation and technical assistance"[3].

Therefore, the FTAA aims to create a deeper level of integration by the removal of trade barriers and building upon WTO's undertaking. The effort to unite the economies of the Americas into a single free trade area and accelerate growth in intra-regional trade in the Americas is embodied in the FTAA.

In response to the deepening phenomenon of globalization and the emergence and expansion of regional economic blocs, the Caribbean Community and Common Market (CARICOM)[4] decided that it was time to deepen the integration process and in 1989, at Grand Anse in Granada, the Heads of Government of Caricom at their tenth conference

was on the development of a common policy to protect industries in the Caribbean from competition from extra regional imports by means of a Common External Tariff (CET).

The main objective of the CSME is the creation of a single economic space which will provide for inter alia, the free movement of goods and services, labour and capital. The movement towards the implementation of the CSME focuses on member states' efforts at re-orienting their policies that will not only allow them to survive in an increasingly competitive environment, but also to achieve economic growth and development for the benefit of the economies in the Community.

4.2: Structure, Process and Rules Governing WTO, FTAA and CSME

The WTO has almost 150 members, accounting for approximately 97% of world trade. These member countries are categorized as least-developed, developing and developed countries. Of the 150 WTO member countries, 21% are least developed, while 67% are developing and the remaining 12% comprise developed countries. Most agreements in the WTO are arrived at by consensus but where consensus cannot be reached, decisions are made by majority votes, cast on a 'one country', one vote basis. All the agreements have been ratified by the member states' parliaments.

The WTO's highest authority is the Ministerial Conference, in which representatives from all countries, usually trade ministers, meet at least once every two years. After this is the General Council which composed of representatives of all the Members, who meet several times a year in the Geneva headquarter. The General Council also meets as the Trade Policy Review Body and the Dispute Settlement Body. Following are the Goods

The rules governing WTO agreements on trade in goods are based on the principles of trade without discrimination, that is, the most favoured nation treatment in which there will be no special deals to trading partners. Also, there must be no national special treatment, locals and foreigners must be treated equally. There should be predictability through binding, where there should be no rise in tariffs, while at the same time promoting fair competition and encouraging development and economic reform. On the other hand, trade in services is governed by the General Agreement in Trade in Services (GATS) principles. Overall, WTO is striving for freer trade.

Similarly, the FTAA negotiations are carried out under an agreed structure that is member-driven and ensures broad geographical participation. The Chairmanship of the entire process, the site of the negotiations themselves, and the Chairs and Vice Chairs of the various negotiating groups and other committees and groups all rotate among participating countries. The Chairmanship of the Negotiations rotates approximately every eighteen months, or at the conclusion of each Ministerial meeting.

The Ministers Responsible for Trade carries out the general management of the negotiations and they meet every eighteen months in the country which is holding the FTAA Chairmanship. Following are the Vice Ministers, who make up the Trade Negotiations Committee (TNC). The TNC guides the work of the negotiating groups and other committees and groups and decide on the overall architecture of the agreement and institutional issues. Further, the Ministers are responsible for ensuring the full participation of all the countries in the FTAA process, ensuring transparency in the negotiations, overseeing the administrative secretariat and overseeing the identification

negotiating groups have specific mandates from Ministers and the TNC to negotiate agreements in their subject area and meet regularly throughout the year.

Added, three (3) Committees and Groups were formed to address horizontal issues related to the negotiations. The Committees and Groups are Consultative Group on Smaller Economies, the Committee of Government Representatives on the Participation of Civil Society and the Joint Government-Private Sector Committee of Experts on Electronic Commerce. Moreover, a Technical Committee of Institutional Issues was created to consider the overall architecture of an FTAA agreement (general and institutional matters). Finally, an ad hoc group of experts was established to report to the TNC on the implementation of customs-related business facilitation measures.

Importantly, Caribbean countries have been actively involved in FTAA negotiations. In March 1996, at the second Trade Ministerial meeting, Jamaica was chosen as Chairman of the Smaller Economies Consultative Group. In November 1999, at the fifth Trade Ministerial meeting, The Bahamas held the post of vice-chairman of the said group.

The FTAA was created in conformity with the provisions of the Agreement establishing the WTO, as commitment was made to build on existing sub regional and bilateral arrangements. Hence, FTAA was created in accordance with Article XXIV of GATT 1994 and its Uruguay Round Understanding and Article V of GATS. Therefore, the same principles that apply to GATT and GATS are utilized in the FTAA agreements. Currently however, FTAA negotiations have stalled for over twelve months, thus signaling that the 2005 implementation date will not be possible, since all agreements have not been

and Planning (COFAP), The Council for Foreign and Community Relations (COFCOR), The Council for Trade and Economic Development (COTED) and The Council for Human and Social Development (COHSOD).

CSME is scheduled to be effected through nine (9) major Protocols, which were signed by most member states[5]. These Protocols require the declaration of Provisional Application by member states to enable them to enter into force. Efforts are being made to have all nine (9) protocols consolidated into a single text, the Revised Treaty of Chaguaramas, which will become the formal framework and constituent element for CSME. Member states are required to carry out specific functions and adhere to states rules under each protocol.

Protocol one deals with the restructuring of the organs and institutions of CARICOM and procedures of the Community. This protocol modifies the unanimity rule for decision making which has impeded prompt decision-making by member states. The second protocol, which is viewed as the most important new instrument in establishing the CSME as a single economic space, addresses the right of establishment, provision of services and movement of capital. The main objective of this protocol is to facilitate trade and investment in the services sector of member states through the establishment of economic enterprises. The aim of this protocol is to complete the creation of the Single Market by adding to the free movement of goods, the free movement of services, capital and selected categories of skills and the right of CARICOM nationals to set up businesses in any CARICOM country. In addition, it is to ensure national treatment that of non-discrimination of CARICOM nationals who wish to carry out business in any member

single enterprises with branches. subsidiaries or joint venture arrangements in more than one member state. It is believed that this protocol will enhance the region's international competitiveness in the sustainable production of both manufactured goods and services. The fourth protocol is mainly concerned with consolidating various amendments to the trade provision of the Treaty that were introduced over the years.

The remaining protocols, (5-9) addresses the following areas: agricultural policy; transportation policy; disadvantaged countries, regions & sectors; competition policy, consumer protection & dumping and subsidies; and dispute settlement.

Section 5: Implications of Service Liberalization on Monetary Policy in The Bahamas

Section 5.1: WTO, FTAA and CSME Liberalization of Services

All three trade agreements have a common goal, that of fostering economic growth and development through trade and services liberalization. It has been stated that the liberalization of trade in goods has been one of the greatest contributors to economic growth and the reduction in poverty. However, as a result of the huge growth of the services economy and the greater potential for trading in services, brought about by the communication revolution, the idea of introducing rules on services came into being. The service sector is the largest and fastest growing sector of the world economy, accounting for more than 60% of global output and in many countries an even greater share of employment. Hence, the lack of a legal framework for international services trade was deemed anomalous, because the potential benefits of services liberalization are as great as

international trade in services. GATS basic principles are: [6]most-favoured-nation treatment which applies to all services, except the one-off temporary exemptions; national treatment which applies in the areas where commitments are made; standard of treatment; transparency in regulations; unrestricted international payments and 'non-discriminatory' market access. Under GATS individual commitments principle countries are required to state which of their services sectors they are willing to open to foreign competition and how open those markets will operate.

Under GATS, the rules apply to four different modes of supplying a service. Namely, (1) cross border, that is services that flow from one country to another, such as banking; (2) consumption abroad, a consumer such as a tourist travels into another country to obtain the service; (3) commercial presence, whereby a company enters the local market of another to provide domestic services such as hotels or insurance; and (4) movement of people, in which workers move to another country to supply a service.

Moreover, GATS has become both the WTO and FTAA umbrella agreement for trade in services. It has annexes dealing with specific sectors such as movement of natural persons, financial services, telecommunications and air transport services.

The CSME protocol two on services also cover similar areas, such as free movement of capital, selected categories of skilled labour, removal of exchange controls, integration of capital markets and the right of establishment.

Section 5.2: Issues and Implications for Monetary Policy in The Bahamas

According to the World Travel and Tourism Council, tourism is the world's largest employer accounting for one in ten workers worldwide. Therefore, the common intention of WTO, FTAA and CSME, which is to spur economic growth by removing barriers limiting trade in services and enabling countries to attract foreign investment by opening "highly regulated" services to international competition, can stimulate economic growth in The Bahamas and the Caribbean as a whole. Undoubtly, an efficient services infrastructure is criterion for economic success. Services, such as banking, insurance, telecommunications and transport, supply strategically important inputs for all sectors, goods and services. Without the spur of competition, these sectors are unlikely to excel to the detriment of overall economic efficiency and growth.

However, the scope and pace of liberalization of financial services need to be properly structured to enable The Bahamas to pursue its development strategy. With the liberalization in trade in services The Bahamas stands to benefit from an influx of foreign investment, thus an increase in net capital flows, impacting positively on foreign currency inflows and international reserves. Nevertheless, with GATS, FTAA and CSME proposal of allowing capital to flow freely, The Bahamas will be forced to abolish if not all, most capital controls and other regulatory measures, including exchange controls restrictions.

It was Krugman (1998) who stated that, as long as capital is allowed to flow freely nations will be vulnerable to self-fulfilling attacks and policymakers will be forced to play the confidence game. Thus, the call by the WTO, FTAA and CSME for unrestricted capital flows can have a destabilizing effect on short term capital flows in The Bahamas. The treaty which makes it easier for capital to flow uninhibited across boundaries can

case The Bahamas, could become vulnerable to panic-induced capital outflows, as well as a run on the currency, thus affecting the level of foreign reserves.

The scenario for The Bahamas is that if the Central Bank does not have a high ratio of foreign currency reserves relative to the short term debt, this can pose a threat to the United States dollar parity. An increase in demand for domestic currency, so as to get the same amount of dollars for debt service and the selling of domestic currency to get those dollars or other "hard" currencies, could drive the value of the domestic currency down. With a high level of short-term international debt, a depreciation of the domestic currency increases the cost of debt service. Thus, the reserves will shrink as more and more investors convert their domestic currency and domestic assets into dollars. This could lead to foreign lenders refusing to renew short term loans, causing a downward spiral.

Moreso, if the definition for investment includes not only foreign direct investment but also portfolio investment and other forms of short-term lending, then the most volatile kinds of flows such as short-term financial credits to banks and large domestic firms, short-term deposits by non-residents in the domestic financial system and purchases of stocks and bonds by non-residents can be included. Hence, it is these types of short-term and speculative capital flows that are likely to exacerbate a crisis when they are sharply reversed since these types of transactions are more likely to be for the purpose of taking advantage of interest rate differentials or in some instances to get quick capital.

Further, the requirement that foreign investors be treated no less favourably than domestic investors, regardless of the circumstances is another cause of concern to The

Depending on the provisions of the definition of investment, transfers and national treatment that the WTO and FTAA will incorporate, this could create major obstacles to any government seeking to regulate short-term speculative capital flows, even to prevent or manage a financial crisis. The Asian and Mexican crises are useful examples of the potential dangers unchecked capital movement can create. According to Bhagwati (1998), the Asian crisis cannot be separated from the excessive borrowings of foreign short-term capital as Asian economies loosened up their capital account controls, thus enabling their banks and firms to borrow abroad. However, a reversal in capital flows amounting to 11.0% of the regional GDP occurred, resulting in 'herd' behaviour, with foreign and domestic investors stampeding for the exits for fear of being caught with depreciated local currency and assets, thus, perpetuating the crisis.

Imperative to note is that, if any of these free trade areas (WTO, FTAA and CSME) make it mandatory for The Bahamas to allow unrestricted transfer of capital relating to investments, including principal, profits, dividends, interest and capital gains, then the possibility exist that The Bahamas will have to abolish all controls that are currently applied to investment entering and leaving the country[7]. The exchange controls that are currently administered by the central bank will no longer be needed and foreign exchange will be allowed to flow freely into and out of the country. This free flow can prove disastrous for the economy since this can result in the confidence in the Bahamian dollar being weakened thus posing a major threat to the fixed parity between the Bahamian dollar and the United States dollar that has prevailed since 1973.

Removal of exchange controls can result in tremendous pressure on foreign reserves, thus

rate, which can diverge significantly from the official rate. All this can climax into the devaluation of the Bahamian dollar.

Generally, governments have always insisted that foreign investors take steps that ensure benefits to local economies. However, under WTO/FTAA/CSME governments could be barred from employing means such as equity capital, or performance requirements in areas such as technology transfer or public service provisions given the most favoured nation principle, which requires governments to treat service providers from all other member countries in the same manner as local providers.

With the most-favoured and no special treatment principles, The Bahamas and all Caribbean countries that enjoyed preferential access to the United States and European Union markets will be deprived of such treatment. Caribbean Basin Initiative (CBI) countries that have one way preferential access to the United States market under the CBI will be forced to compete with the rest of Latin America and the Caribbean in attracting investment and they will lose by having to grant reciprocal access to their market in place of one-way preferences.

Moreover, the WTO market access rule and CSME right of establishment principle can adversely affect local interest. According to these rules, foreign services providers must be granted unrestricted entry into all sectors. These rules conflict with The Bahamas investment laws[8] which stipulate that certain service-oriented sectors be reserved exclusively for Bahamians. Enforcing of these rules would mean that all reserved areas can be opened to competition, thus possibly adversely affecting local businesses, some of

Internal Revenue Services), which individually identified various aspect of the offshore financial services in the country that posed significant concerns, thus leading to blacklisting of the country. In the wake of these supra-national directives and the impending US Treasury led Qualified Jurisdictions (QJs), the Government embarked on extensive overhauling of the financial sector legislation enacting nine (9) new laws on the 29th December, 2000. These are, The Bank and Trust Companies Regulation Act 2000, The Central Bank of The Bahamas Act 2000, The Financial Intelligence Unit Act 2000, The Financial Transactions Reporting Act 2000, The Financial and Corporate Services Providers Act 2000, The Proceeds of Crime Act 2000, The International Business Companies Act 2000, The Evidence (Proceedings in other Jurisdictions) Act 2000 and Criminal Justice (International Cooperation) Act 2000.

In general, The Bahamas and all other Caribbean economies are highly vulnerable to external shocks created from the liberalization of trade in goods and services. Caribbean countries are vulnerable to the loss of preference and to overall changes in the world market as a consequence of goods and services liberalization.

Section 6: Recommendations and General Findings

Within the global economy, services represent the fastest growing sector accounting for some 60% of global output, 30% of global employment and approximately 20% of global trade. Therefore, the liberalization of the services sector is inevitable since there are benefits to be accrued from services liberalization. With services liberalization, there can be enhanced economic performance since an efficient service infrastructure is a

While, there are real potential benefits from the liberalization of services, the results for developing countries have been mixed. GATS provisions are often said to be development-friendly, since WTO/FTAA members can choose which sectors to liberalize and what limitations to put on the liberalization process. Nevertheless, in reality developing countries are often subjected to unyielding pressure to liberalize all their services sectors.

Services liberalization can prove challenging to CARICOM countries due to their inability to compete with the developed countries, their lack of diversification, the loss of trade preferences and their vulnerability to external shocks, both man-made and natural. Hence, in the absence of special remedial measures, the equal treatment of un-equals (developed and developing countries) is almost certain to accentuate inequality.

Therefore, it is important for The Bahamas and other CARICOM countries to preserve a 'policy space' for themselves in the new international environment. These countries should ensure that room for maneuvering is available when negotiating international services and investments agreements, so as to ensure that they are able to further their national economic interests.

It is recommended therefore, that no provision should be adopted which restricts the government from imposing limits on currency convertibility during times of financial crisis, or under circumstances in which the government determines that such action is in the national interest. Further, no provision should be adopted which restricts the

According to Agosin and Ffrench-Davis (1996), who conducted extensive research into the role of capital flows and capital controls, governments should adopt "speed bumps" reserve requirements and other types of capital controls to shield their economies from the destabilizing effects of short-term capital flows. Before negotiating any treaty that prohibits capital controls, the government of The Bahamas should consider the impact of speculative capital flows as well as international capital mobility.

A build-up in short-term international borrowing can cause the Bahamian economy to become vulnerable to panic-induced capital outflows. Therefore, there is need for some capital controls to remain in place, since these controls could prevent excessive and volatile capital inflows from building up initially. The adoption of 'speed bumps' reserve requirement should be considered, since the reserve requirement would permit the government to maintain a degree of control over monetary policy. With the 'speed bump' reserve, it can be requested that foreign investors place a specific percentage of their investment into a zero-interest account with the Central Bank with the requirement that these reserves be maintained at the Bank for a minimum of 90 days.

Therefore, studies need to be conducted on the sequencing of services liberalization. The timing of the liberalization and the method for implementing liberalization strategy are very important. Liberalization should not be implemented too fast and should be supported by 'appropriate' macroeconomic policy.

Further, since monetary policy cannot be disassociated from fiscal policy, prudent fiscal measures are needed to complement monetary policy. It is necessary for the Government

income taxes and value added taxes. Therefore, reforming the tax system is necessary, even though this will prove costly both administratively and politically.

In conclusion it is important to note that, negotiations of WTO and FTAA will continue, inspite of countries decisions. Therefore, even though not explicitly stated, countries cannot refuse to be a part of these free trade agreements. A country standing alone is no longer a wise decision. Isolation would only prove 'economically suicidal' since the country would end up being excluded from all the benefits, although limited for some countries, associated with being a member of any such trade and services agreement. Being a member of WTO/FTAA/CSME can help promote economic growth by enhancing competition and efficiency. However, given the basic principles governing these agreements (WTO/FTAA/CSME), the government should exercise the 'right to regulate' all liberalized services so as to maximize the benefits and minimize the costs that can result from becoming a member of either WTO, FTAA or CSME. Strong regulatory bodies are essential if The Bahamas and all other Caricom countries are to benefit from services liberalization.

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