IMPLICATIONS OF THE GLOBAL CREDIT CRISIS FOR THE BAHAMIAN ECONOMY

Background

The subprime mortgage crisis in the United States has caused significant turbulence in global financial markets, placing a large number of financial institutions at risk of failure and resulting in a sudden reduction in liquidity for the provision of credit to businesses and households. The outward manifestation of the crisis has been the large decrease in equity prices on the major stock markets, weakness in the US dollar and continued prospects for sustained to rising oil and commodity prices. The outlook for the stability of global financial markets hinges on the successful conclusion of an agreement between the US President and the Congress on a financial rescue measure—the major component of which involves the provision of an estimated $700 billion in funds to purchase bad mortgages currently on the books of US banks. This will provide liquid resources to support a resumption in lending to businesses and households, and avert any severe contraction in the US economy. Nevertheless, the continued adjustment to the subprime crisis is expected to have real economic consequences that soften the outlook for the Bahamian economy.

The Origins and Nature of the Sub-Prime Crisis

The US sub-prime mortgage market is an innovation of the last decade, where institutions provided high, often variable interest rate loans to high credit risk households. This fueled strong growth in mortgage lending to such households. The abundance of funds within the US financial system and the low interest rate environment also facilitated accelerated mortgage lending to medium and low risk borrowers. These loans were repackaged as interest paying (mortgage backed) securities and sold, among others, to investment banks and institutional investors (including pension funds) who took on the direct risk of loses in the event of mortgage defaults.

With the 2007 slowdown in the US economy and the cumulative impact of rising interest rates since 2004 both sub-prime borrowers and households of lesser credit risk started to experience greater difficulties repaying mortgages. There was a spike in incidents of mortgages defaults, a surge in home foreclosures and a glut of unsold houses that caused a sharp drop in residential real estate prices. In response to the deteriorating quality of loans, lending intuitions have had to increase provisions for hundreds of billions of dollars in mortgage losses. These institutions now face a need to raise new capital to support their operations, at a time when investors are reluctant to commit such resources. This has been a primary source of market instability, as the traded value of financial institutions' shares has fallen sharply. A number of institutions have either failed or been taken over and the US government has had to inject considerable equity into the country's two largest mortgage lenders.[1] Direct investors in sub-prime securities have also witnessed a significant depreciation in the traded value of their assets that has exposed some of them to the risk of failure.

Investors' reluctance to inject much needed funds into the markets could further derail lending institutions' ability to provide new credit to businesses and households and impede other companies' ability raise funds in the capital markets. The rescue package presently making its way through the US Congress is expected to restore some confidence to markets. It is being supplemented by coordinated monetary and fiscal support in other major economies, also designed to provide liquidity and bolster market confidence.

IMPACT ON THE BAHAMAS

Banks and Trust Companies

To gauge the potential impact of the recent mortgage turbulence on The Bahamas' banking operations, the Central Bank requested all licensees to quantify and report on their on and off balance sheet exposures to these developments. To date, domestic banks have reported no exposure, with preliminary reports for the offshore banks indicating minimal direct exposure, although some of their head offices were significantly impacted.

[1] **Fannie Mae and Freddie Mac.**

The very international nature of these operations and the continuing level of uncertainty in financial markets, means that we at the Central Bank will continue to monitor these developments very closely, in conjunction with home supervisors of these entities.

Domestic Financial Sector

The ongoing crisis in US financial markets, highlighted by the failure of leading financial institutions, has sparked some concern among Bahamian depositors regarding the safety of their deposits.

The Central Bank wishes to assure the public that the stability of the domestic financial sector is not threatened by the developments in the US. The credit exposure of our domestic banking institutions is largely to Bahamian households and denominated in Bahamian dollars, with only a small percentage of foreign currency lending to the public sector and to private businesses that are mainly involved in the hotel sector or export manufacturing businesses. There are no sub-prime loans in the domestic banking sector. All loans, including mortgages, are subject to rigorous qualifying criteria to assess the borrowers' ability to service the debt as well as the existence of appropriate collateral requirements, as set out in the Central Bank's guidelines following the removal of the credit restrictions in August 2004. Because of Exchange Control restrictions, monies saved by Bahamians in domestic banks remain in The Bahamas and are employed to fund credit within the economy. As such, depositors should not be concerned about the safety of their funds placed with domestic banks

The public should also be aware that The Bahamas does have in place a deposit insurance scheme, which provides a safety net, should a domestic bank encounter financial difficulties which could lead to its inability to continue operations. The Deposit Insurance Fund insures deposits up to a maximum of B$50,000 held by any individual or company in any one financial institution.

The Central Bank acknowledges that there has been an increase in the level of non-performing loans, which at end-August, stood at 10.7% of total loans compared with 9.2% at end-December 2007. The impact of the economic slowing has been most pronounced on the commercial sector, whose operations have been adversely affected by increased operating costs and reduced revenues; and an increasing number of loans are now more than three months in payments arrears. This situation is likely to continue in the near-term, until the economic situation shows renewed signs of improvement.

External Reserves

The foreign reserves of the Central Bank are the largest stock of Bahamian assets held outside The Bahamas, and these are not invested in the capital markets and therefore not exposed to turbulent swings in equity prices. Based on the Central Bank Act and internal investment guidelines, these can only be held in deposits of the highest rated banks, the debt securities of a limited number of international institutions (including the World Bank, Bank for International Settlements [BIS], Inter-American Development Bank [IDB], the US government, US government guaranteed securities, and major central banks (Federal Reserve, Bank of England, European Central Bank, Bank of Canada). Moreover, all foreign securities held by the Central Bank have maturities of not more than 5 years, to limit price sensitivity to interest rate changes. So far, our assessment indicates that external reserve holdings are not exposed to any undue risks.

Real Sector Economic Activity

Notwithstanding the growing signs of global economic weakness in the opening months of 2008, there were signs of positive momentum in the domestic economy, associated with tourism and other real sector activity. However, with the deepening and broadening of the financial sector crisis in recent weeks, the short-to medium-term uncertainty for the Bahamian economy increases—with implications for employment, inflation and government revenue performance.

Tourism and Foreign Investment

US consumer confidence is an important determinant of domestic tourism performance, and this indicator has definitely weakened in recent months. A continuation of this trend is certain to further constrain travel demand and hinder output growth. However, some offset to this possibility could stem from the weak US dollar. Financial markets have already begun to factor the impact of the $700 billion rescue package on the increase in US government debt and the depressing effects on the dollar. For US vacationers, this will allow The Bahamas' to stay comparatively more affordable against destinations such as Europe and Asia that are priced in currencies that have strengthened against the dollar. Nevertheless, the dollar's weakness could sustain the uptrend in consumer prices and could either ignite a further rise in oil and commodity prices or at the very least delay any significant short-term easing in these costs. Consequently, Bahamians may be confronted with elevated cost of living increases in the short-term.

To the extent that the international financial markets remain unsettled in the near-term, it is highly likely that there will be a reduction in the availability of credit, and an increase in borrowing costs. As a result, foreign investors' ability to obtain funding for projects being undertaken in The Bahamas and activity in the second homes market are likely to be impeded, resulting in either delays or scaling back in these activities. These outcomes would have consequential negative implications for construction activity and employment.

Conclusion

This environment of heightened uncertainty requires consumers, who also have to deal with the continuing impact of rising oil and food prices, to exercise prudence and constraint in their spending. All non-essential outlays and the taking on of new debt should be minimized or even deferred.

The Central Bank will continue to monitor domestic and external developments and to take measures consistent with ensuring the overall stability of the financial system and the sustainability of credit and external reserves trends.