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The Commonwealth of The Bahamas

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The Commonwealth of The Bahamas

Major Rating Factors

Sovereign Credit Rating
BBB+/Stable/A-2

Strengths:

- A track record of macroeconomic stability.
- Political stability and high per capita GDP.
- A favorable composition of government debt associated with low public-sector external indebtedness.

Weaknesses:

- Rising fiscal debt and deficits given increased spending and a narrow revenue base that has declined amid the economic recession.
- An open and narrowly based economy that has modest growth prospects, depends highly on the U.S. economy, and is vulnerable to adverse external developments.
- A high current account deficit and weak external liquidity.

Rationale

The ratings on The Commonwealth of The Bahamas reflect the government's weakened fiscal profile. The sovereign's debt and deficits have increased, and the composition of its debt has weakened somewhat. In addition, following three years of economic contraction (including a projected decline in GDP in 2010), The Bahamas' growth prospects are projected to remain modest beginning in 2011. A combination of higher debt levels and a subdued growth outlook has weakened the sovereign's fiscal profile.

Net general government debt was 30% of GDP in 2009, up from 22% in 2008, and Standard & Poor's Ratings Services projects that it will continue to rise--to 34%-38% of GDP in 2010-2012. (Gross general government debt is higher at 45% of GDP in 2009, up from 37% in 2008.) The Commonwealth's share of external to locally issued debt is 20%, which is relatively low but up from 10% in 2007. Higher debt reflects rising fiscal deficits that resulted from The Bahamas' undertaking countercyclical fiscal spending as its already-narrow revenue base declined. Specifically, the government has increased capital and social spending to mitigate the impact of the recession on society. At the same time, revenues fell by 9.2% in the fiscal year ended June 30, 2009, and Standard & Poor's expects them to contract again in the fiscal year ending June 30, 2010. Compounding revenue vulnerability is The Bahamas' reliance on taxes on international trade and transactions (more than 50% of tax revenue). The government aims to minimize further declines in revenue by modernizing collection mechanisms, especially at customs. Overall, we project a general government deficit of 4.8% of GDP in the fiscal year ending June 2010, from an estimated 4.1% of GDP in fiscal 2009. During 2010-2012, we project general government deficits will average 3.5% of GDP, compared with deficits of 1.5% of GDP in 2003-2007.

We expect that real GDP in The Bahamas contracted 4% in 2009 and will contract another 0.5% in 2010 before returning to growth of almost 2% in 2011. The country's dependence on one product (tourism accounts for more than 50% of GDP and employs over 50% of labor force) and one market (U.S. tourists account for more than 80% of the total) dampens prospects for a robust economic recovery over the coming years. Standard & Poor's forecasts a comparatively weak U.S recovery versus past U.S. recoveries. The Bahamian hotel industry sees stabilization in the sector, but it does not expect a meaningful revival of tourism until 2011. In addition, once-buoyant prospects for a major expansion of tourism projects are now more muted. Although high-end niche projects continue to advance, many others have been delayed. In the midst of the slowdown in tourism and construction, unemployment rose to 14.2% in 2009--its highest level since the early 1990s and a jump from 8.7% in 2008.

Outlook

The stable outlook reflects Standard & Poor's expectation that the government will gradually reduce its fiscal deficit and will maintain a generally stable external financing profile. We do not expect The Bahamas' tourism sector to improve sharply until the U.S. economic (and U.S. consumer) recovery has consolidated. In the meantime, the government is working to put the offshore financial sector, a second economic pillar, on stronger footing after it was included on the G-20/OECD grey list of offshore financial centers. The authorities negotiated 20 Tax Information Exchange Agreements (TIEAs) and got off the grey list in March 2010. (The grey list is a list of countries that the G-20 and/or OECD consider to be tax havens, namely with taxes that are levied at very low rates or not at all.) Although The Bahamas' external financing gap (defined as current account payments plus short-term debt plus medium- and long-term amortization) is high at about 135% of current account receipts and usable reserves, it improved in 2009 amid a lower current account deficit (CAD) and higher international reserves. Importantly, the government's external amortization needs are low, and the bank's foreign depositor base remains stable. We expect financing needs to remain, on balance, largely the same in 2010-2011. The ratings could come under pressure if The Bahamas' fiscal deterioration persists and the economic base erodes more severely. Conversely, we could raise the ratings if the government takes a more proactive policy response to reduce debt levels or if the Commonwealth's economic prospects strengthen.

Table 1

The Commonwealth of The Bahamas--Selected Indicators

	--Year ended Dec. 31--						
	2006	**2007**	**2008**	**2009e**	**2010f**	**2011f**	**2012f**
GDP per capita ($)	22,223	22,577	22,465	21,449	21,433	22,099	22,559
Real GDP (% change)	4.3	0.7	(1.7)	(4.0)	(0.5)	2.0	2.5
Real GDP per capita (% change)	2.8	(0.6)	(3.0)	(5.3)	(1.9)	0.8	(0.4)
General government balance (% of GDP)*	(1.8)	(1.1)	(4.1)	(4.8)	(4.6)	(3.1)	(2.7)
General government debt (% of GDP)	32.8	35.2	36.6	45.4	49.5	51.9	52.4
Net general government debt (% of GDP)	19.0	19.8	22.4	29.8	34.2	37.1	38.4
General government interest expense (% of revenues)*	8.0	8.3	10.5	11.8	12.5	11.4	11.8
Domestic credit to private sector and NFPEs (% of GDP)	83.4	87.6	92.3	95.2	95.2	94.9	94.7
Consumer price index (average % change)	2.3	2.9	4.5	2.1	2.0	2.3	2.3
Gross external financing needs (% of CARs and usable reserves)¶	144.7	145.6	152.2	134.9	133.6	138.4	146.2
Current account balance (% of GDP)	(18.6)	(17.3)	(15.1)	(8.2)	(9.0)	(9.8)	(11.5)
External debt net of liquid assets (% of CARs)	17.7	15.0	15.5	18.7	22.1	22.9	25.0

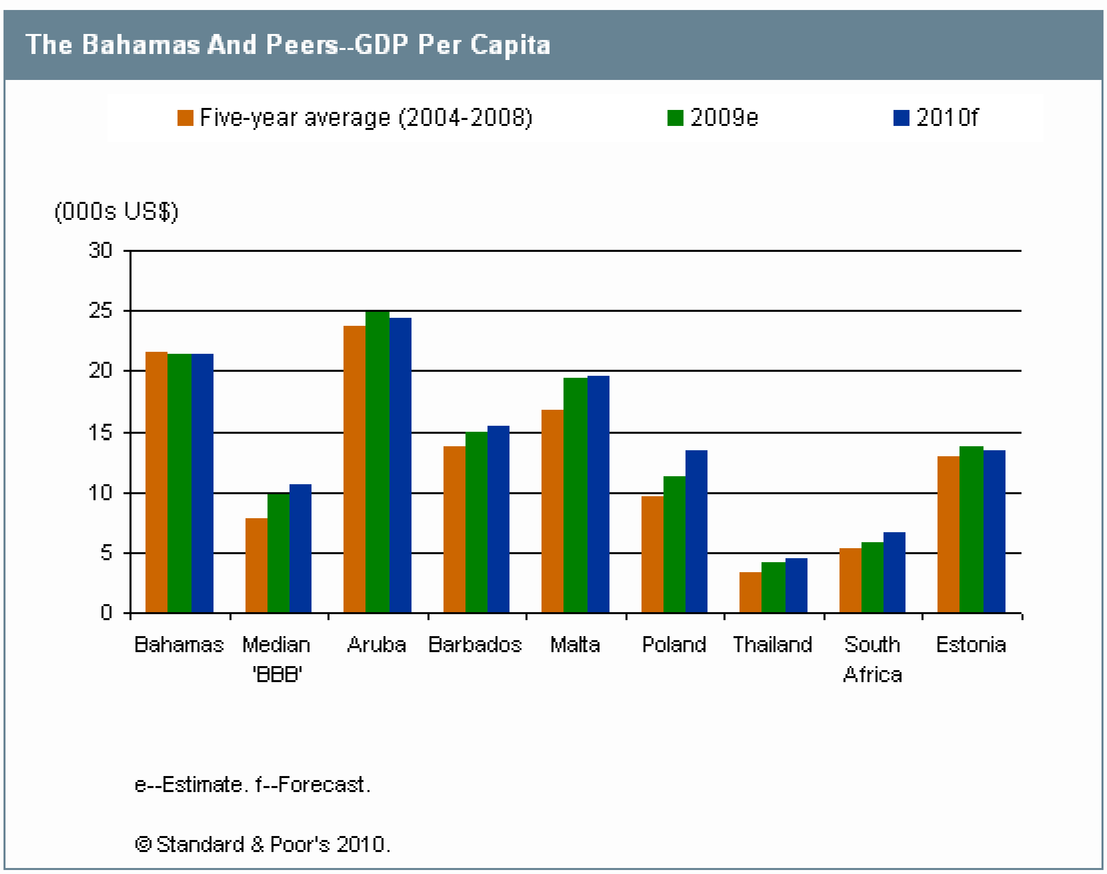
f--Forecast. e--Estimate. NFPEs--Nonfinancial public sector enterprises. CARs--Current account receipts. *Data on a fiscal-year basis (ending June 30). ¶Usable reserves are adjusted for 100% of the monetary base.

Comparative Analysis: Dependence On The U.S. Weakens A Historically Prosperous Economy

Greater political stability and stronger institutions

Political stability, widespread consensus on major economic reform, established democratic institutions, and strong judicial systems characterize The Bahamas and its closest peers: the Republic of Malta (A/Stable/A-1), Aruba (A-/Stable/A-2), and Barbados (BBB/Negative/A-3). (Ratings are foreign-currency sovereign credit ratings as of April 28, 2010.) A track record of macroeconomic stability and an economy based on tourism and the financial sector have produced a high level of wealth in The Bahamas. Accordingly, The Bahamas' GDP per capita, at a projected US$21,433 in 2010, is more than double the 'BBB' median of US$10,545. It is most similar to that of higher-rated peers, Aruba and Malta (see chart 1). At the same time, the broader human development indicators in The Bahamas are somewhat weaker than those of its peers. The Bahamas ranks 52nd out of 182 countries in the 2009 United Nations Human Development Index and is classified as a having high human development. Barbados, which comes in 37th, and Malta (38th) are classified as having very high human development. Other high human development peers are Estonia (A-/Negative/A-2) and Poland (A-/Stable/A-2), which are ranked 40th and 41st, respectively. Thailand (BBB+/Negative/A-2) and South Africa (BBB+/Negative/A-2) have medium human development, according to the index, and rank 87th and 129th, respectively.

Chart 1

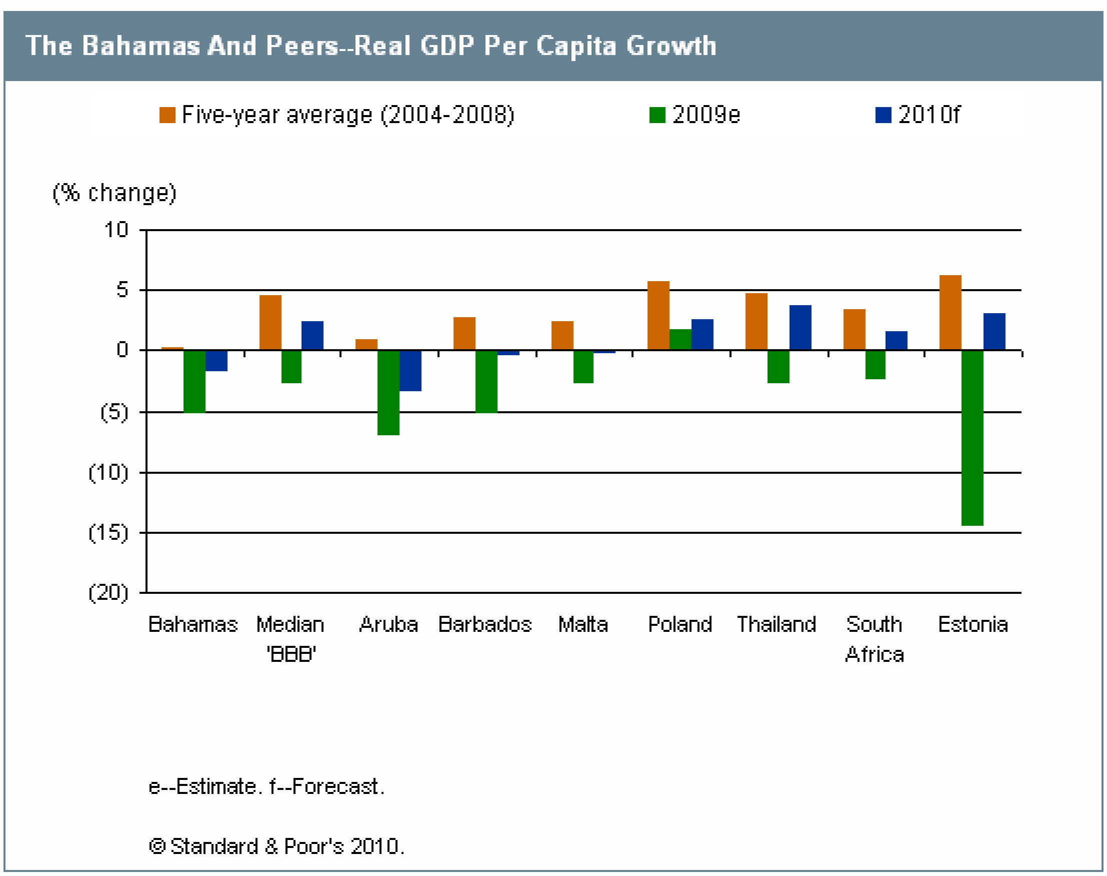


Economic structure becomes a more pronounced credit weakness

The structure of The Bahamas' small, export-oriented economy is similar to that of some of its rated peers. Export exposure, with CAR at 46% of GDP for The Bahamas, is less than the 'BBB' median of 54% and is below that of Barbados (50%) and Aruba (78%). Similar to its Caribbean peers, The Bahamas' export inflows are not diversified and reflect the economy's heavy dependence on tourism (more than 50% of GDP and more than 50% of the labor force) and, to a lesser degree, on financial services (20% of GDP). Dependence on a single market, the U.S., which is The Bahamas' main trading, tourism, and investment partner, exacerbates this concentration. Tourism is slightly more diversified in Barbados and Aruba. The economies of Poland, Estonia, Thailand and South Africa are more diversified.

The Bahamian economy contracted an average of 0.3% per year on a per capita basis from 2002-2009 as a result of its narrow economy and close economic ties to the U.S. This lags the growth rates of most peers and is less than the 'BBB' median of 3.7% growth (see chart 2). The weaker performance results from several factors. These include the adverse weather conditions that The Bahamas, like other Caribbean islands, is susceptible to; a lackluster tourism arrival performance over the past few years; greater competition in the tourism industry; and the global recession in 2008-2009. Medium-term growth prospects remain subdued.

Chart 2



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Debt level likely will be near the 'BBB' median and lower than a number of peers' despite deteriorating economic conditions

Amid economic contraction and the increased use of countercyclical fiscal policy, fiscal deficits have widened and debt levels have risen. Deficits average 4.2% of GDP in 2009-2011, compared with an average of 3.3% for the 'BBB' median. They are weaker than those of some issuers such as Aruba and Thailand but are stronger than others such as South Africa's (see chart 3). The heavy dependence on taxes on international transactions (responsible for about 50% of revenue) and a general consensus opposing the introduction of direct taxation limit fiscal flexibility in The Bahamas. Barbados favorably distinguished itself from many Caribbean countries by introducing a value-added tax (VAT). The government cannot sustain the expansionary fiscal stance for a long period of time because it would eventually put pressure on the fixed exchange rate regime. However, the currently moderate general government debt levels temporarily provide some space for fiscal weakening compared with other 'BBB' rated peers. The Bahamas' net general government debt, which increased to 30% of GDP in 2009 and is projected to rise further to 34% in 2010, is in line with the 'BBB' median and lower than Barbados' (see chart 4).

Chart 3

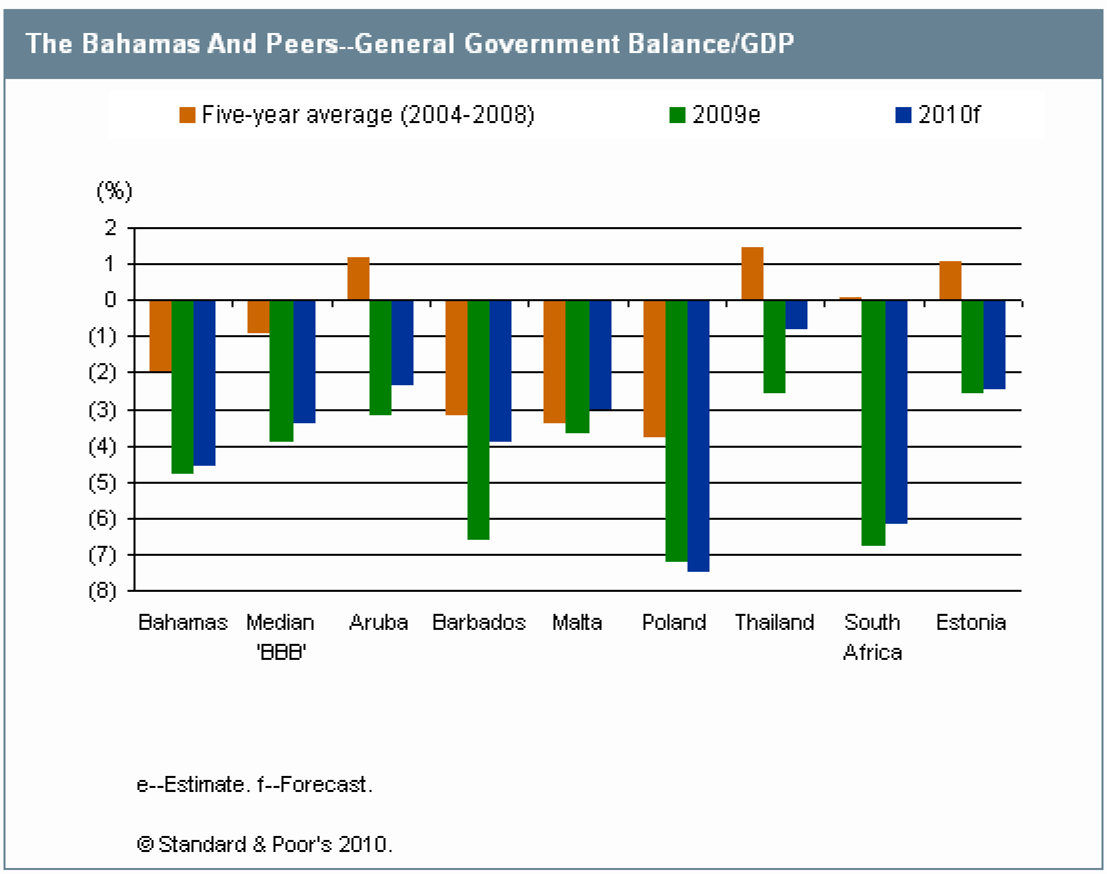
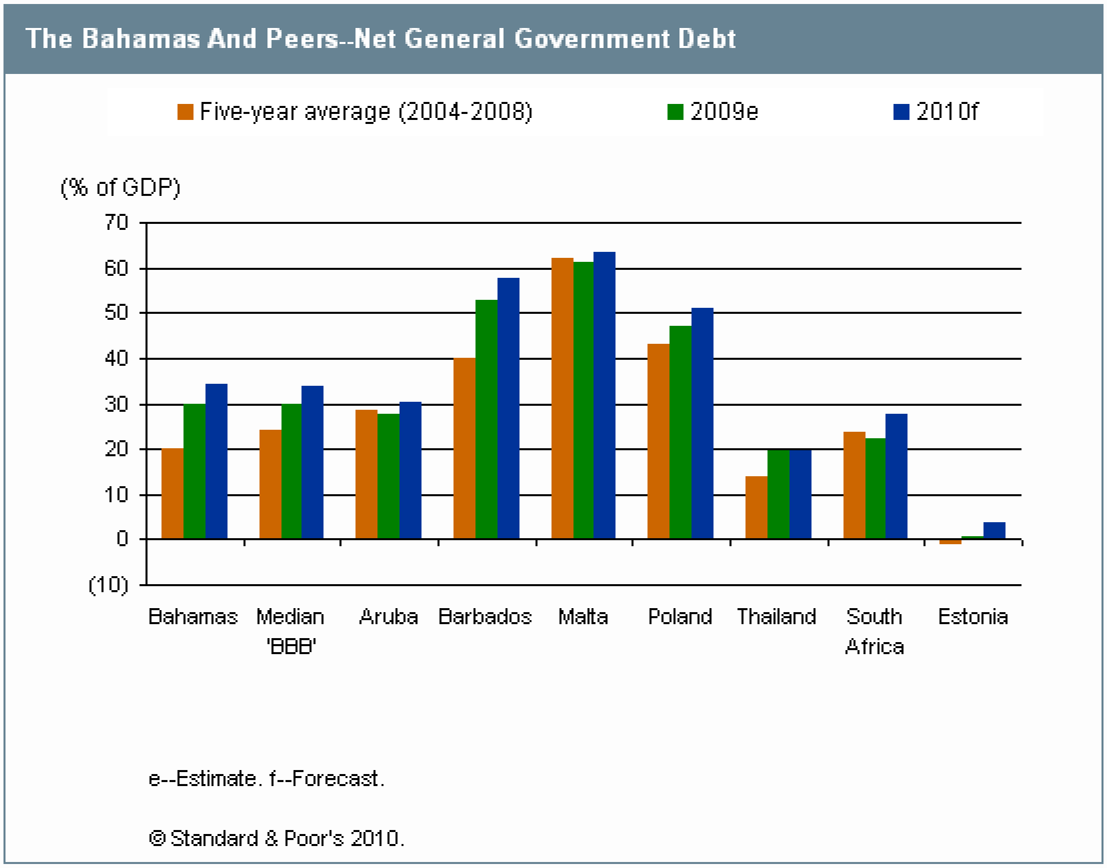
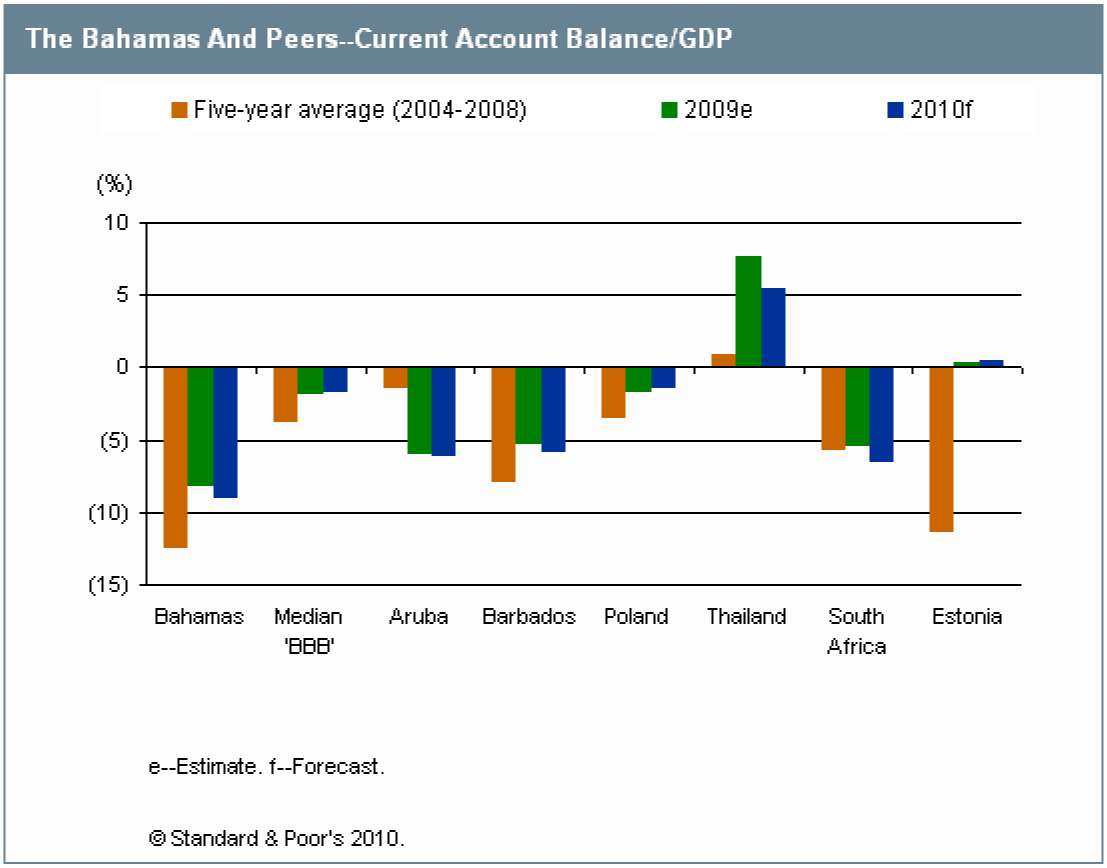


Chart 4



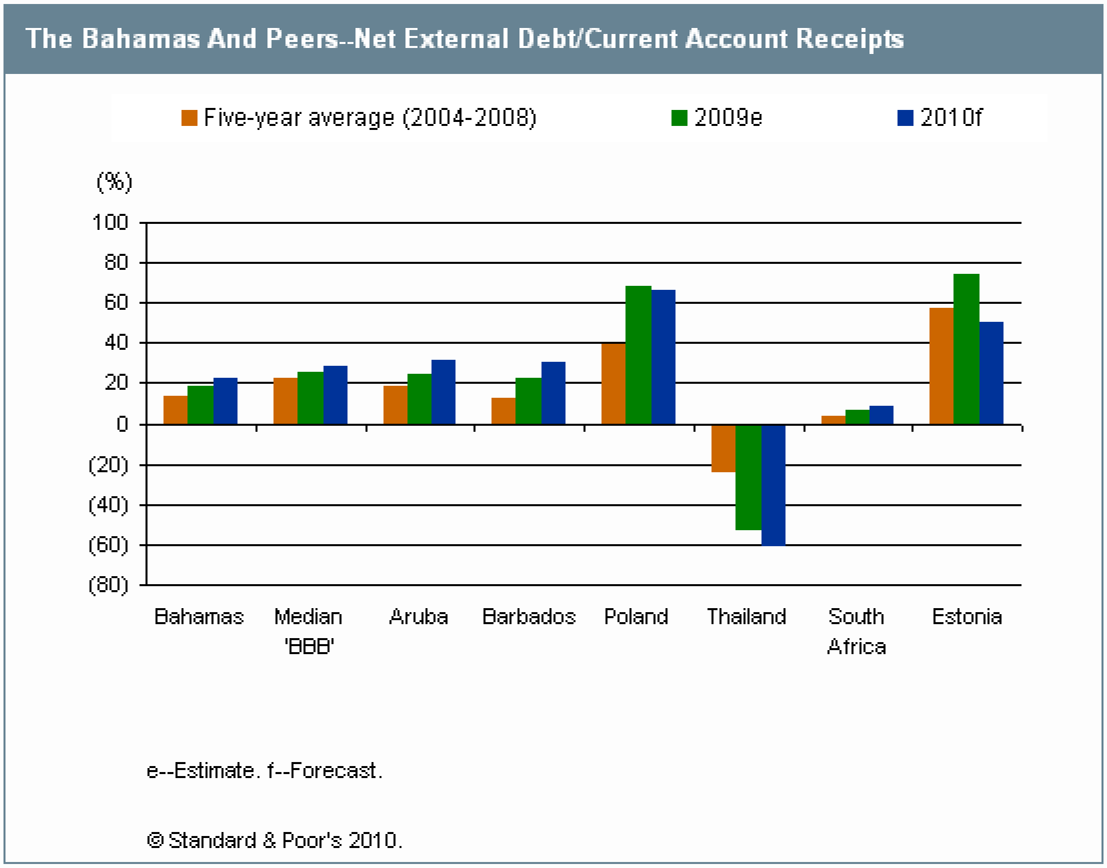
The Bahamian economy depends heavily on imports as a result of its small size, openness, and the capital-intensive nature of tourism projects. Although the sovereign's CAD declined sharply in 2009 and likely will remain closer to this lower level over the next several years, it is still higher than peers' (see chart 5).

Chart 5



Despite the high CAD, The Bahamas historically had financed the deficit through foreign direct investment (FDI) and positive large errors and omissions. The recent increase in public-sector external debt underlies the increase in the country's external debt. External debt net of liquid assets at 22% of CAR in 2010 is below the 'BBB' median, less than that of Aruba.

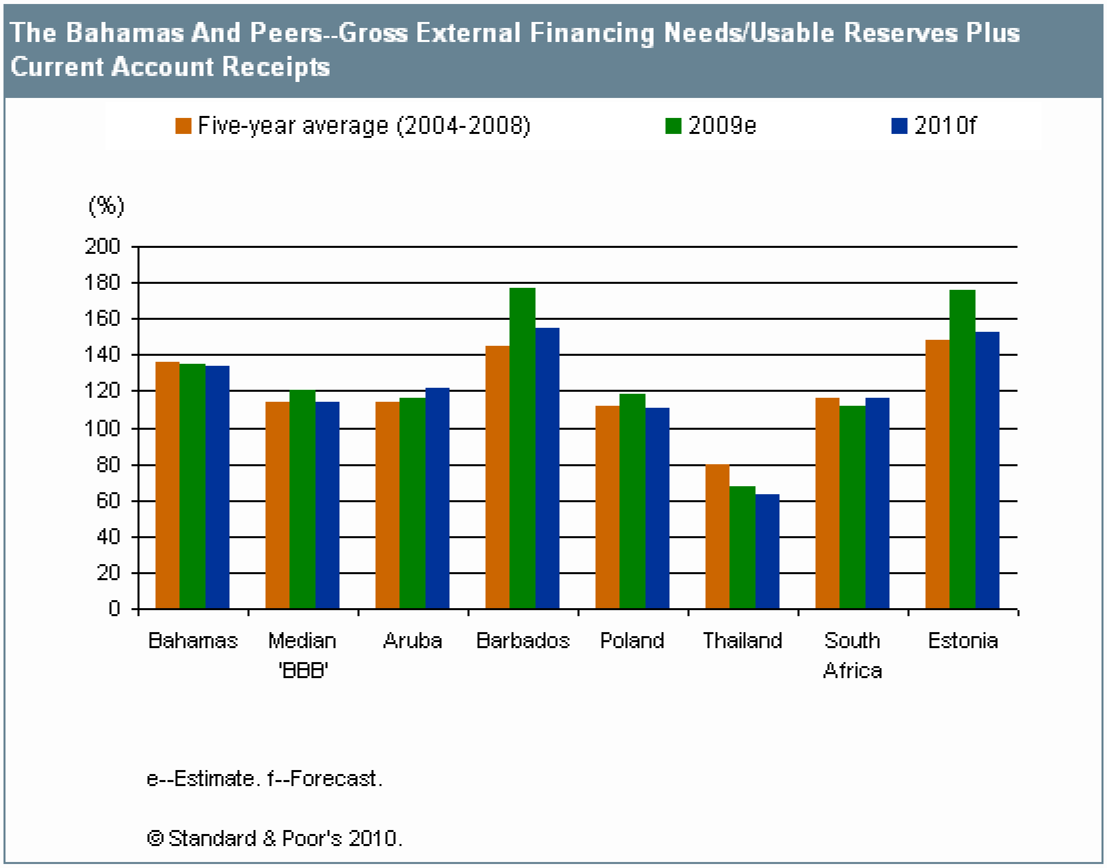
Chart 6



Weak, but stable, external liquidity

As a result of the high CAD and the banking sector's substantial external liabilities, The Bahamas' liquidity ratio is weak. Gross financing needs have averaged 140% of CAR and usable reserves in the past five years (2005-2009), but they improved in 2009 given higher international reserves and a lower CAD. At a projected 134% of CAR and usable reserves in 2010, financing needs are better than Barbados' but weaker than those of Aruba, the 'BBB' median, and a number of other peers (see chart 7).

Chart 7



Political Environment: Government Faces Challenges As It Tries To Mitigate The Recession's Impact

- The government faces some difficulties in policymaking as it attempts to balance social pressures and economic discipline.
- The government's agenda includes improving transparency and conditions for business.
- Financial centers and tax havens are experiencing renewed global pressure.

The Free National Movement (FNM) party, which won the general elections in May 2007, faces the tough task of leading the country through the current turbulent economic times. Prime Minister Hubert Ingraham led the government through the 2001 U.S. slowdown during his previous term in office in 1992-2002. However, the current economic downturn is more severe and has lasted longer. The government has taken a number of steps to mitigate the social impact of the recession. It introduced unemployment benefits funded from the national insurance scheme in April 2009 and a national six-month public/private-sector job initiative program in December 2009. In addition, it increased social transfers, offered temporary tax relief for the electricity company to improve distribution of electricity, encouraged banks to work out the debt repayment solutions with the debtors in arrears, and budgeted capital works projects to support the social safety net. And, an increase in public concern is pressing the government to address rising crime rates. Safety in The Bahamas continued to deteriorate in 2009, with the number of murders up 25% in the first eight months of the year versus the same period in 2008. Nevertheless, other crimes (burglaries) were down, despite the recession.

The FNM party won the 2007 elections on the mandate of increased transparency, with the party's Trust Agenda focusing on accountability and transparency issues, strengthening the institutional framework, and promoting better governance. On the back of these promises, the government initiated a widespread review of the public contracts upon assuming the office in mid-2007. This stalled numerous investment projects, some of which have only recently moved forward, such as the signing of the construction contract for the Straw Market in December 2009. In mid-2009, the government presented a discussion paper on improving the accountability and transparency of government administration that it plans to use as a basis for a new Financial Administration and Audit Act for Parliament to consider. It is also working with the Inter-American Development Bank (IADB) to improve management in the public sector, because the IADB characterizes the government as lacking strategic management, and to ensure the prerequisite resources to effectively follow up on project execution.

The government has highlighted its plans to strengthen conditions for business in The Bahamas. Its pending agenda includes amendments to the Business License Act to facilitate operating a business and streamlining the regulation of nonbank financial services. According to the World Bank's Ease of Doing Business Index, The Bahamas raking continued to deteriorate, falling to 68 from 59 (from 1 to 183, with 1 being the best) last year. The particular weaknesses are in the areas of construction permits, property registrations, investor protection, and contract enforcement.

Along with the rest of the world, The Bahamas' financial sector likely will continue to face competitive pressure. The Bahamas' financial sector encompasses banking, private banking and trust services, investment fund administration, investment advisory services, etc. Renewed pressure from the OECD/G-20 in April 2009 led to The Bahamas being put on the grey list for financial centers operating as tax havens. The Bahamas worked quickly to satisfy the requirement of signing 12 TIEAs by March 31, 2010, in order to be removed from the grey list. The government successfully concluded its 20th TIEA, 14 of which are with OECD countries and seven with G-20 countries by that deadline. This demonstrates the Bahamian government's longstanding commitment to preserve the integrity of its offshore banking system; in 2002, The Bahamas successfully cleared its name after being put on the OECD blacklist in 2000. Despite being taken off the grey list this year, the Bahamian local industry continues to voice concern about the government's ability to maintain the competitiveness of the financial sector given the expectation that financial centers likely will remain under policymakers' scrutiny worldwide.

In the international arena, The Bahamas maintains good relations with the U.S., Canada, and Europe. Establishing legislation against drugs and money laundering was an important policy step. Although The Bahamas is a member of the Caribbean Community, the country decided not to participate in the Caribbean Single Market and Economy (CSME). The Bahamian population is most concerned about the CSME's provision for free movement of labor (given the vast difference between the average wages in The Bahamas and other Caribbean countries) and the lack of trade benefit from such a union for The Bahamas. The country trades mostly with the U.S., while the trade of CSME participants is more regionally oriented. The Bahamas also continues to oppose any free-trade agreements (FTAs), including the Economic Partnership Agreement (EPA) with the EU.

Economic Prospects: Stalled Tourism Projects And A High Unemployment Rate

- The narrowly based Bahamian economy depends on tourism from the U.S. and the financial service sector.
- We project real GDP will contract slightly in 2010 and then grow moderately in the following years.
- The status of the numerous tourism investment projects is mixed, with niche projects moving forward and others stalled given the global economic backdrop.

Table 2

The Commonwealth of The Bahamas--Economic And Financial Indicators

	--Year ended Dec. 31--						
	2006	**2007**	**2008**	**2009e**	**2010f**	**2011f**	**2012f**
Nominal GDP (bil. $)	7.3	7.5	7.6	7.3	7.4	7.7	8.1
GDP per capita ($)	22,223	22,577	22,465	21,449	21,433	22,099	22,559
Real GDP (% change)	4.3	0.7	(1.7)	(4.0)	(0.5)	2.0	2.5
Real GDP per capita (% change)	2.8	(0.6)	(3.0)	(5.3)	(1.9)	0.8	(0.4)
Unemployment rate (% average)	7.6	7.9	8.7	14.2	14.5	12.0	10.0
Consumer price index (% change)	2.3	2.9	4.5	2.1	2.0	2.3	2.3
Domestic credit to private sector and NFPEs (% change)	15.6	8.2	6.2	(0.1)	1.3	4.0	4.8
Domestic credit to private sector and NFPEs (% of GDP)	83.4	87.6	92.3	95.2	95.2	94.9	94.7
Financial sector contingent liability/GDP (%)	16.7	17.5	18.5	19.0	19.0	19.0	18.9

f--Forecast. e--Estimate. NFPEs--Nonfinancial public sector enterprises.

The Bahamian economy is small, open and narrowly based--relying predominantly on tourism and offshore financial services. Tourism accounts for more than 50% of GDP and employs more than 50% of the labor force. The Central Bank of the Bahamas' annual survey on the contribution of the financial sector to the economy concluded that the sector accounts for at least 15% of GDP, led by banks and trust companies, but a smaller 3% of the employed, in 2008.

Over the years, tourism has benefited from the country's proximity to the U.S., the strong brand name of the Atlantis resort, the country's dominant position as a cruise line destination, and a strong inflow of tourism investments. However, these factors turned against the country given the U.S. recession and the outlook for modest growth in the U.S. over the next several years. This has magnified The Bahamas' high vulnerability stemming from its dependence on one market, tourism, with U.S. tourists accounting for about 80% of the total.

After posting real GDP growth of 5.7% in 2005, momentum slowed sharply and then the economy contracted. In 2007, the increase in real GDP was a mere 0.7% as growth was interrupted, first by the elections and then by the new administration's protracted period of reviewing contracts after it came into office in May 2007. The review of $80 million worth of contracts and the eventual cancellation of a $23 million public contract for the Straw Market negatively affected investor sentiment and brought substantial disruption to the contractors' activity. (The Straw Market project didn't move back on track until December 2009, when the government signed a construction contract.) Then, in 2008 the economy contracted 1.7% because of slowing domestic activity and the negative impact of the U.S. recession. The damage from the two major storms that hit the Bahamas in late August and early September 2008 further weakened the economy.

Real GDP in The Bahamas likely contracted 4% in 2009, and we project it will decline another 0.5% in 2010 before returning to growth of 2% in 2011 and 2.5% in 2012.

All sectors of the Bahamian economy have felt the impact of the U.S. recession. Weak domestic consumption, tourism, and construction associated with FDI led to estimated economic contraction in 2009. The Bahamas' dependence on tourism from the U.S. clouds prospects for a robust economic recovery given that Standard & Poor's forecasts modest growth for the U.S.

The Bahamas' tourism sector has weakened since 2004, with total and stay-over arrivals declining annually since then. In essence, the industry was experiencing difficulties even before the full effects of the international economic crisis took hold. These include the reconstruction of local resorts and the unavailability of rooms from 2005-2007, as well as the requirement (effective in 2006) for U.S. citizens to have a passport to travel to The Bahamas. Following a 4.6% decline in total tourist arrivals in 2008, tourism arrivals increased 5% overall through the third quarter of 2009--this is in line with preliminary data for all of 2009 from the Bahamas Hotel Association. But, the improvement in 2009 reflected less-lucrative cruise arrivals (in terms of local visitor expenditure), which were up 15% through third-quarter 2009 over the same period in 2008. Air arrivals, however, were down 13% in the third quarter of 2009 compared with third-quarter 2008.

According to the Bahamas Hotel Association's annual survey in early 2010, the industry expects improvement in 2010, namely stabilization in the sector given signs of recovery at the end of 2009. The industry expects employment to hold steady and does not expect to rehire the employees that were fired in 2008-2009. The industry expects occupancy to rise somewhat in 2010, along with capital spending. The occupancy rate was 60% in January 2010 (versus 70% in January 2007 (according to the hotel association). The better outlook for 2010 also follows from the government's progress in securing additional and more affordable airlift by the end of 2009 given persistent pressure from the tourism sector. This followed the loss of scheduled flights during the high season of October 2008 through March 2009 and a reduction in the marketing efforts from the major hotels. The government redoubled marketing efforts to promote The Bahamas and has focused on securing better airlift connections to the Family Islands and the main resort in Grand Bahama. A joint public-private sector initiative includes a companion-fly-free initiative.

Once buoyant prospects for a major expansion of tourism projects, totaling more than US$10 billion over the next five to 10 years, are more subdued. The slowdown in construction in 2009, despite some public works projects, reflects the slowdown in foreign tourism projects, which includes construction of second homes and real-estate presales to finance tourism investments. According to some members of the government, the Bahamas' strategy for the tourism sector is to develop smaller, boutique-type developments and eco-sensitive tourism. The Baker's Bay Golf And Ocean Club is an example of such an eco-resort. Very high-end, niche projects continue to advance because of their exclusivity and the prefunding of many of these projects. These include the Cat Island PGA village (with the first PGA golf course outside the U.S.), the Albany project in New Providence (with million dollar homes, golf courses, marina), and The Ritz Carlton Rose Island Development (on a smaller scale than originally planned).

Although smaller tourism projects continue to move ahead, albeit at a slower pace, the speed of the largest scale projects--Ginn sur Mer and Bahama--is more uncertain. It is these projects that would more dramatically alter the scale of tourism in The Bahamas. The development of the US$4.9 billion Ginn sur Mer mega resort on Grand Bahama--which should take 10 years--continues at a very slow pace given the economic hit to the housing sector in the U.S.; resolution of the legal problems following the bankruptcy of its owners are slowly being worked out. The main idea behind the project is to alleviate marina congestion in Florida by bringing yachts to Grand Bahama (only 40 minutes away) with a large residential, marina community. The stalled US$2.6 billion Bahamar redevelopment project at Cable Beach, New Providence could be progressing. As of March 2010, the developers were in talks regarding funding with new potential partners, the China Export-Import Bank and China State Construction Engineering Corp. The project would provide another tourism anchor to nearby Atlantis resort and casino for the singles crowd.

In the midst of the slowdown in tourism and construction, unemployment has risen to its highest levels since the early 1990s, despite government efforts to address unemployment through higher capital spending aimed at creating jobs (and new unemployment benefits). The unemployment rate was at 14.2% in 2009, up from 8.7% in 2008. In New Providence it was 14%, while it was 17.4% in Grand Bahama. A major contributor to the high unemployment is hotels, which drastically cut their staff and the employees' workweeks in 2009. For instance, Atlantis, the largest employer in the country outside the government, laid off approximately 800 employees (10% of the total) at the end of 2008 and the beginning 2009. However, the tourism sector expects employment to hold steady in 2010.

Fiscal Flexibility: Deficit Is Widening, But A Track Record Of Sound Fiscal Policy Supports Economic Stability

- The general government deficit rose sharply and likely will average 4.7% of GDP in fiscal 2009/2010 and 2010/2011.
- Increased spending against a narrow revenue base, which has declined amid the economic recession, led to larger deficits.
- We project debt levels will rise, but domestic markets will provide most of the financing.

Table 3

The Commonwealth of The Bahamas--Fiscal Indicators

	--Year ended June 30--						
	2006	2007	2008	2009e	2010f	2011f	2012f
(% of GDP)							
General government revenues	22.0	22.7	20.8	20.4	20.6	21.1	20.9
General government expenditures	23.8	23.9	24.8	25.2	25.2	24.2	23.6
General government balance	(1.8)	(1.1)	(4.1)	(4.8)	(4.6)	(3.1)	(2.7)
General government primary balance	(0.1)	0.8	(1.9)	(2.4)	(2.0)	(0.7)	(0.3)
Central government revenues	18.7	19.4	17.5	17.1	17.3	18.0	18.0
Central government expenditures	21.2	21.2	22.1	22.4	22.3	21.3	20.9
Central government balance	(2.5)	(1.8)	(4.7)	(5.2)	(4.9)	(3.4)	(3.0)
Central government primary balance	(0.8)	0.1	(2.5)	(2.8)	(2.4)	(0.9)	(0.5)
General government balance (% of revenues)	(8.3)	(5.0)	(19.6)	(23.6)	(22.3)	(14.9)	(13.1)
General government interest payments (% of revenues)	8.0	8.3	10.5	11.8	12.5	11.4	11.8
Central government interest payments (% of revenues)	9.4	9.8	12.5	14.0	14.8	14.1	13.7
General government debt*	32.8	35.2	36.6	45.4	49.5	51.9	52.4
General government net debt*	19.0	19.8	22.4	29.8	34.2	37.1	38.4

f--Forecast. e--Estimate. *As of Dec. 30.

Forecasts for higher fiscal deficits

The Bahamas' historical fiscal position, which included small deficits and low debt levels, has been one of the key factors underlying the nation's macroeconomic stability. General government deficits averaged 1.4% of GDP from 2000-2007, with net general government debt of less than 20% of GDP. Given the weakening of the economy that began in 2008, deficit and debt levels have risen, and we project they will remain at higher levels through 2012. We project the general government deficit will remain higher over at an average of 4% of GDP during 2009-2012, with net general government debt rising to 38% of GDP in 2012.

Chart 8

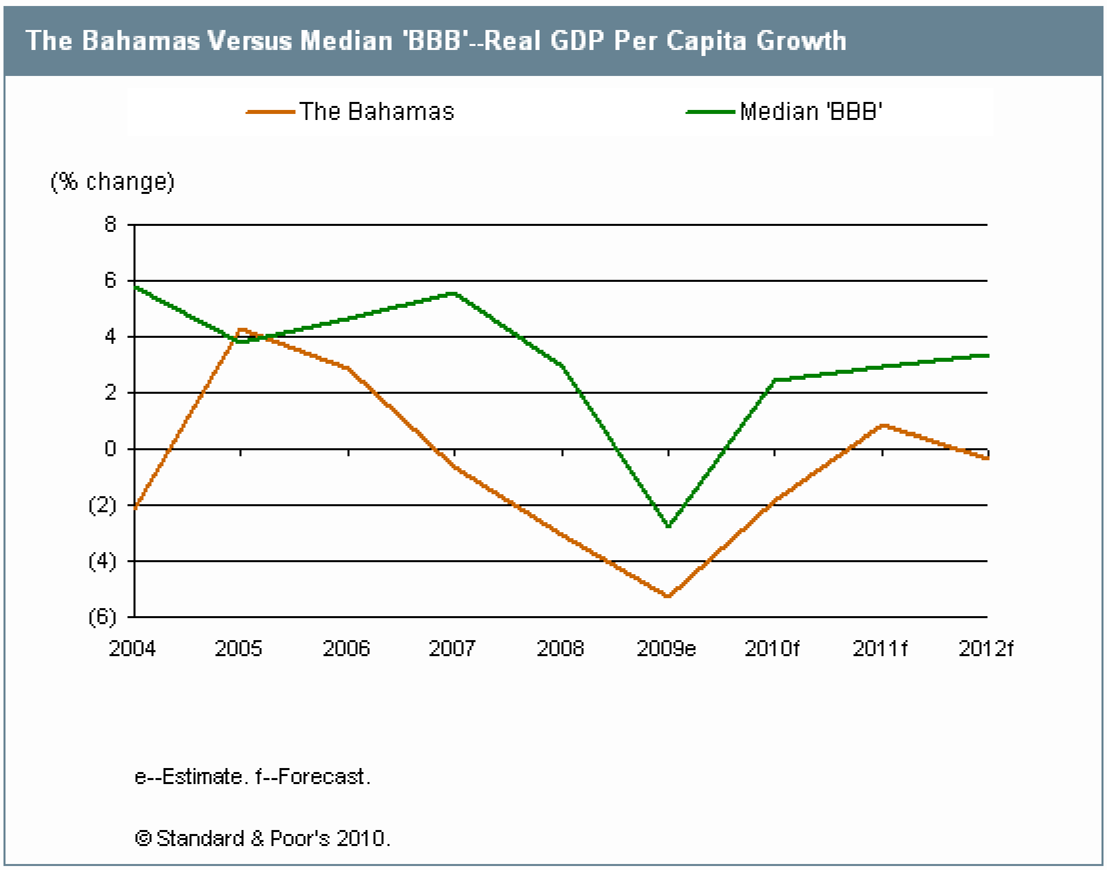
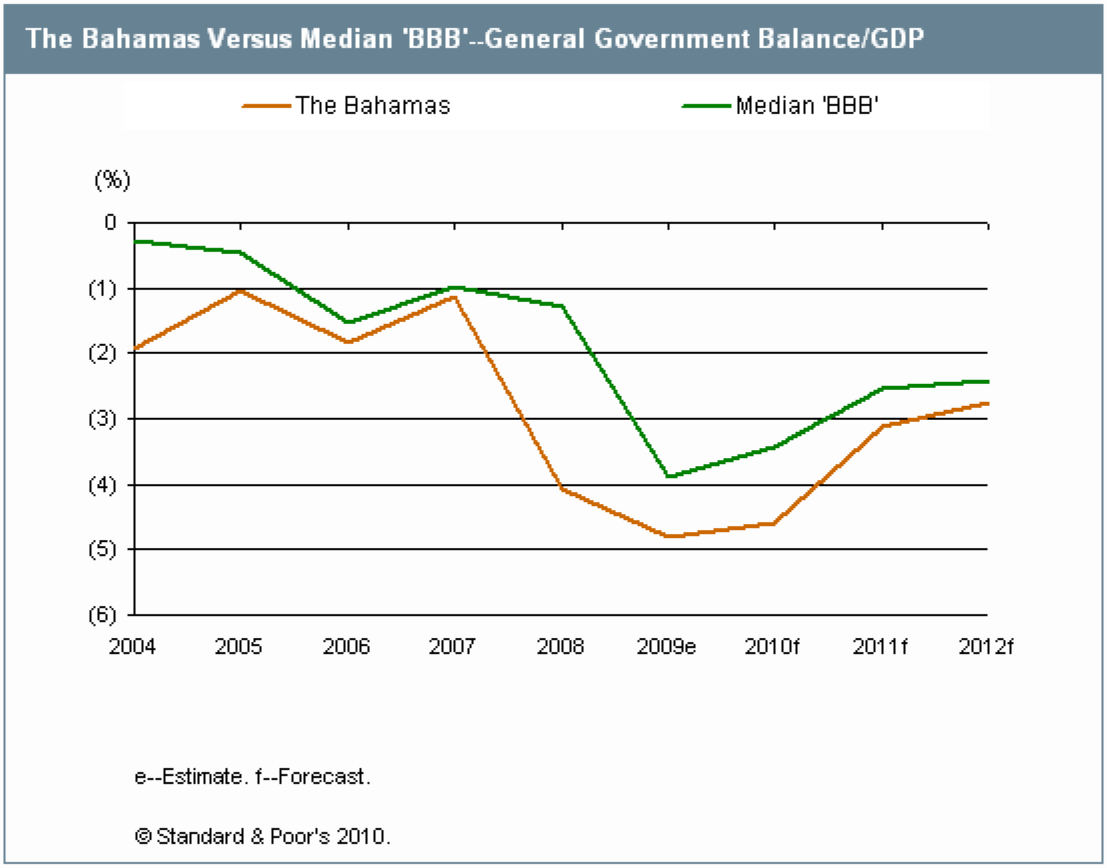


Chart 9



The central government deficit increased to 4.7% of GDP in fiscal 2008 (ended June 30, 2009) from 1.8% in fiscal 2007. Government revenues declined given the economic contraction, and the government continued to raise expenditures as part of its countercyclical fiscal policy efforts. In the budget for the fiscal year ending June 30, 2010, the government envisages a deficit of 3.9% of GDP, as well as the maintenance of a larger deficit over the next several years. In its midyear budget statement (released December 2009), the government acknowledged the likelihood of an even weaker result. Our projection is for a somewhat higher deficit of 5.2% of GDP in fiscal 2010 (ending in June) given continued pressure on revenues. We project a slow decline in the deficit to about 3% of GDP by 2012 as economic conditions strengthen.

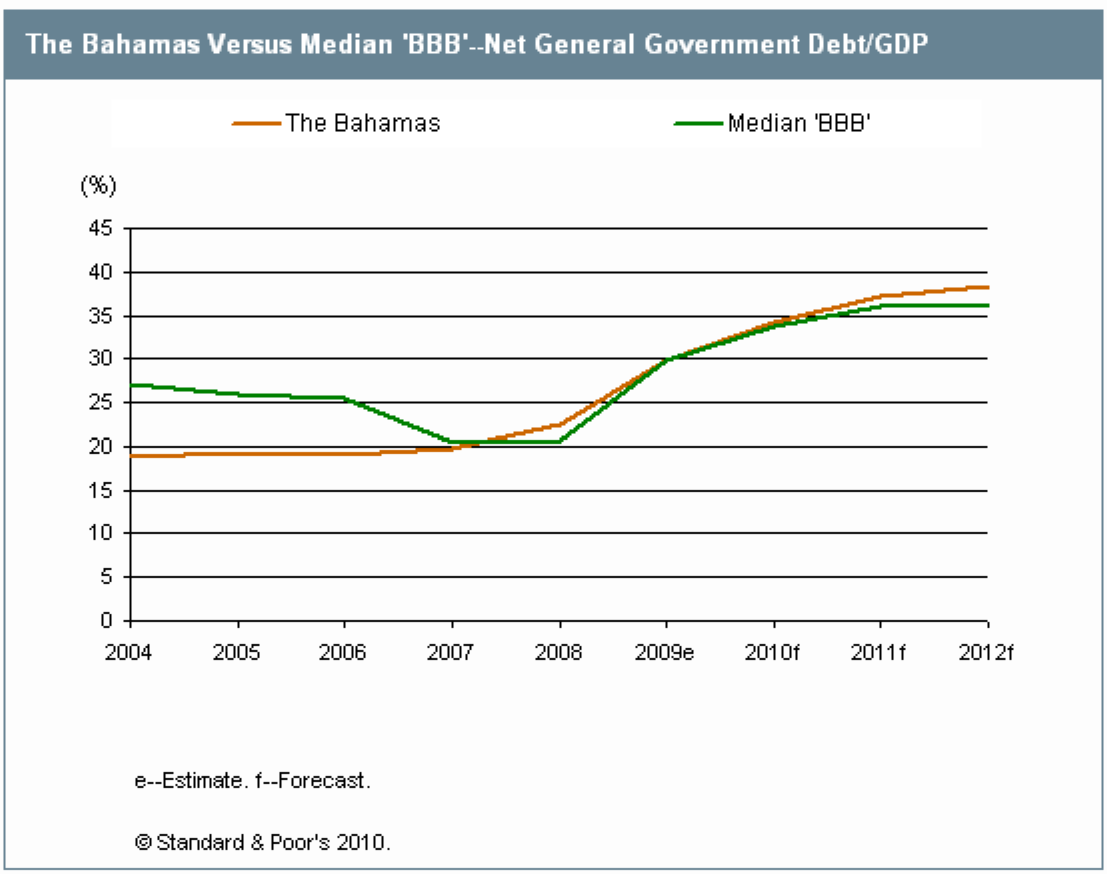
Higher deficits reflect revenue weakness and government policy to alleviate the social impact of the slowing economy and to support growth. Specifically, recognizing the rapid increase in unemployment, the government introduced unemployment benefits in 2009 (funded via the National Insurance Board). This unemployment insurance program, at first temporary, became permanent in 2010, with additional funding from higher employer and employee contributions. In December 2009, the government announced a six-month jobs program/initiative for workers in the public and private sectors. It also enlarged its capital works projects to limit the impact that the slowdown in private-sector projects had on unemployment in the construction sector.

Maintaining a track record of fiscal discipline remains important to the government. To that end, it aims to improve tax collection by appointing new revenue officers throughout Family Islands, overhauling customs, and closing other loopholes in tax collection, namely in the real estate sector. It received technical assistance from the International Monetary Fund (IMF) to enhance revenue administration and is taking steps to implement it. Revenue vulnerability stems from the reliance on taxes on goods/customs (that account for about 50% of tax revenue), which in turn depends on imports and tourism. Introduction of a broad-based consumption VAT could mitigate vulnerability, but is not on the government's agenda. The government had planned to limit transfers to loss-making state enterprises. However, the government already has increased its 2009/2010 budgetary allocation to the Water and Sewage Corp., which remains under financial pressure--it is reportedly running arrears with some suppliers. The government is working with the IADB to improve the Water and Sewage Corp.'s operations.

Debt levels likely will increase

Gross general government was 45% of GDP in 2009, which was up from 36% in 2008. Net of liquid assets, debt was much lower at 30% of GDP but up from 22% in 2008 and less than 20% in prior years. We project gross and net debt to rise to about 52% and 38% of GDP, respectively, by 2012. Interest expenditure rose to 11.8% of general government revenue in 2009 from 10% in 2008 and 8% in previous years. We expect interest expenditure to remain at this higher level over the next several years. Public corporations' debt was 12.5% of GDP as of year-end 2009, of which direct government guarantees to public enterprises account for 8% of GDP. The government doubled the size of guaranteed loans of the Bahamas Electricity Company (BEC) in 2009, shifting them from nonguaranteed status. The BEC began posting operational losses in 2006 amid increased subsidies. Standard & Poor's estimates the contingent liability that the financial sector poses to the sovereign is 19% of GDP, though it could rise if asset quality deteriorates further.

Chart 10



Deficit financing comes predominantly from domestic sources, a credit strength for The Bahamas. The structure of the debt remains favorable, though it has recently relied more on foreign debt. Domestic debt accounted for 90% of total debt in 2007, which declined slightly to 88% in 2008 and further to 80% in 2009. The government plans to maintain a domestic to foreign financing ratio of 2 to 1. The domestic debt maturity profile is favorable. About 87% of locally issued central government debt consists of medium- and long-term bonds in Bahamian dollars, 60% of which mature after 2020.

The government hoped to receive US$200 million-US$300 million in proceeds from the sale of a 51% stake in the Bahamas Telecommunications Co. (BTC) in the first half of 2010 to alleviate financing needs. However, the government has once again postponed the privatization following seemingly disappointment with the bids and prices offered at the end of 2009. Plans to sell BTC have existed since the first Ingraham government, and when it took office again in 2007, it canceled the sale of BTC to Blue Water Communications, which the previous administration had arranged.

Monetary Policy: Low Inflation And Measures To Keep The Financial Sector Strong

- We project inflation in The Bahamas will remain near 2%.
- The growth in domestic credit has slowed as banks increased provisions in the midst of the economic recession and credit quality deterioration.
- The government is taking steps to keep the financial service sector competitive amid heightened global scrutiny of offshore financial centers and weaknesses in nonbank supervision.

Low inflation under a pegged exchange rate regime

Monetary policy is circumscribed by the 1973 decision to set the Bahamian dollar at parity with the U.S. dollar. A moderate level of external reserves, a track record of prudent fiscal policies, and comparatively low levels of government debt support the exchange-rate peg. According to the IMF's estimate, the real effective exchange rate is neither overvalued nor undervalued. Inflation in The Bahamas historically has been low, averaging 2% in the past 10 years. Along with the trend in global inflation, inflation in The Bahamas accelerated in 2008 to 4.5%. The increase was much less than what other areas of the Caribbean experienced, given The Bahamas' outdated basket for consumer price inflation that has a low share of fuel in it and a tax structure reliant on import duties, versus VAT in other Caribbean countries. In 2009, inflation declined, along with global trends. Inflation averaged 2.1% in 2009 and reached 1.3% at year-end 2009. We expect inflation to remain close to 2% over the next several years.

Slower credit growth amid higher NPLs

The central bank's monetary policy instruments are limited--it uses credit ceilings and capital controls the most to influence money supply. Currently, it has no direct credit controls over domestic banks' lending. The most recent controls were in place from 2001-2004. Banks have taken a more cautious approach to lending as unemployment and nonperforming loans (NPLs) have both risen over the past several years. Total credit to the private sector by the banking system stagnated in 2009, growing only 0.1% following 5% growth in 2008 and an average 12.7% growth rate in 2005-2007. Following the abolition of credit restrictions in 2004, consumer lending intensified, especially in the mortgage sector, reflecting pent-up demand. Mortgages, which account for almost 50% of private-sector loans, increased an average of 15% per year during 2005-2007 and then slowed in 2008 and further to 5.9% in 2009. As of December 2009, private-sector loan arrears (over 31 days) were 17.6% of total loans (versus 12.4% in December

2009). Nonperforming loans (those more than 90 days in arrears and on which banks have stopped accruing interest) were 9.4% of total loans (versus 6.1% in December 2008). Segments facing the toughest conditions include consumer loans, mortgages, and commercial loans. Provisions to nonperforming loans were 37.1% at year-end 2009.

Financial sector has an important role

The Bahamas' financial sector plays a significant role in the local economy, with an estimated contribution to the economy worth at least 15% of GDP, and it employs about 5,000 people. As of 2009, 272 banks and trust companies were licensed to operate from or within The Bahamas, and more than three quarters had a physical presence in the jurisdiction. The remaining--mainly G-8 branches--operate under managed arrangements that the Central Bank has approved. Out of eight licensed commercial banks, the majority are subsidiaries of foreign banks. Bahamian banks are the principal channels for allocating resident and nonresident investment, since they are allowed to conduct both onshore and offshore operations. As a result, the accumulation of nonresident deposits on domestic banks' books is quite substantial, reaching 52% of banks' external liabilities (at year-end 2009) and totaling more than 6x the country's GDP and almost 8x the banks' resident deposits. Prudent management practices and a historically good loan portfolio quality, as well as the soundness and stability of the depositor base (mostly Canadian and European), help to counterbalance this huge exposure.

Liquidity in The Bahamas' banking sector, domestic and offshore, has risen over the past two years. This has occurred amid limited domestic credit expansion (including a decline in foreign currency credit) and an increase in international reserves. Excess liquid assets in the financial system totaled Bahamian dollar (B$) 494 million in January 2010, up from B$362 million in January 2009 and B$162 million in January 2008. Foreign exchange reserves were US$796 million in January 2010, up from US$589 million in January 2009 and B$471 million in January 2008.

The Bahamas is in the top category of offshore centers because of its favorable tax regime, adherence to international standards of practice, strong supervision and regulation of banks and trusts, and a pool of financial professionals. The country has worked to improve its regulatory framework over the years. The most recent regulatory improvements include the amendments to the Central Bank's two primary acts--the Central Bank of The Bahamas (Amendment) Act, 2007 and the Banks and Trust Companies Regulation (Amendment) Act, 2007--to allow for the sharing of information with other domestic regulatory authorities. These and other measures taken since 2000 (when The Bahamas was put on the OECD blacklist, from which it was removed two years later) constitute important steps toward better regulation and supervision. In addition, recent steps the sovereign took that led to its removal from the OECD grey list highlight the government's commitment to maintain a competitive offshore financial center. Increased global sensitivity of cross-border tax evasion likely will persist and will underpin ongoing scrutiny of offshore financial sectors. To that end, The Bahamas is also participating in the peer review process of the Global Forum on Transparency and Exchange of Information; it is scheduled for a review in the second half of 2010.

Supervision of nonbank entities (insurance, credit unions, pension funds) does not fall under the Central Bank's purview and is weaker than that for banks. The failure of Clico Bahamas in 2009, under the supervision of the insurance registrar, highlighted such weakness. The 2005 insurance law (consistent with international standards) did not become effective until the passage of additional legislation in May 2009 following the failure of Clico. The failure of Clico has prompted the government to consider streamlining the regulation of nonbank financial services more broadly under a new Financial Services Authority.

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External Finances: Public-Sector Debt Increased In 2009, Though International Reserves Were Also Up

- A lower CAD in 2009-2010 versus recent years reflects the decline in oil prices from their 2008 highs and lower capital imports.
- We expect FDI and tourism receipts to remain low in 2010.
- Public-sector debt rose in 2009, though we believe the external balance sheet will remain relatively stable, with FDI and large errors and omissions continuing to finance most of the current account deficit.

Table 4

The Commonwealth of The Bahamas--External Indicators

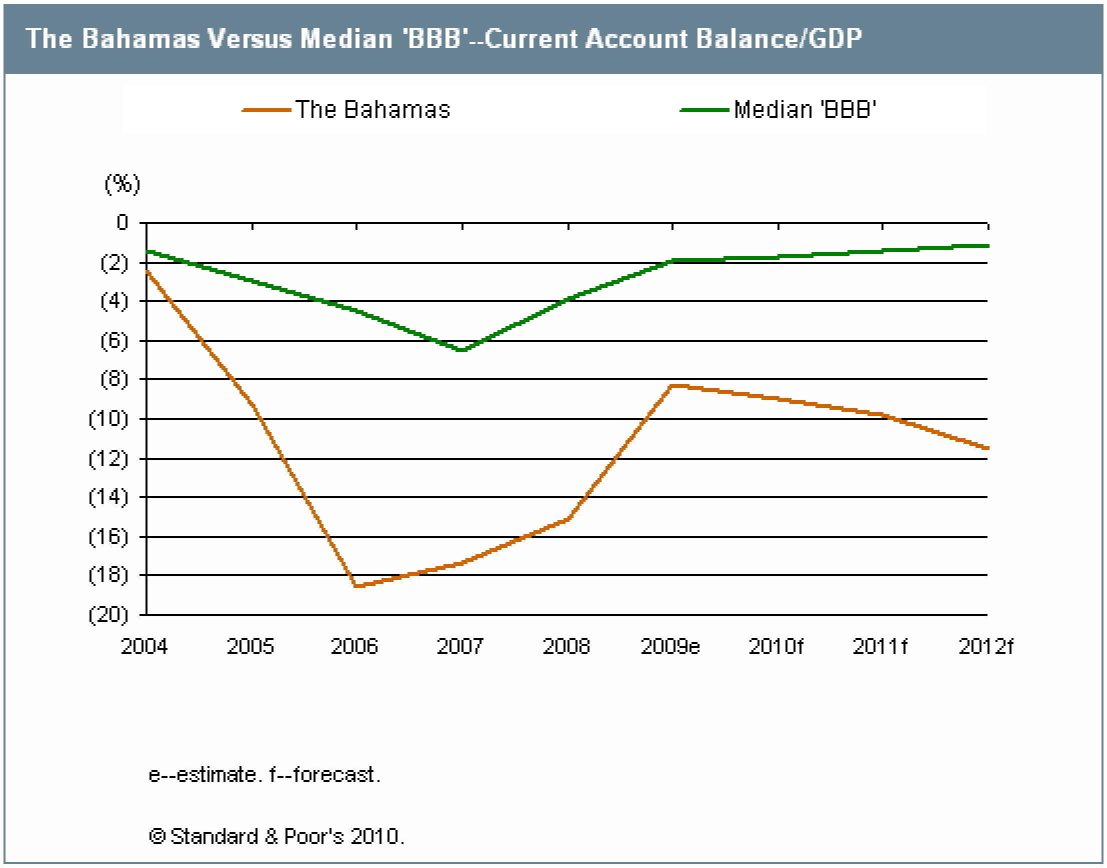
	--Year ended Dec. 31--						
	2006	2007	2008	2009e	2010f	2011f	2012f
(% of GDP)							
Current account balance	(18.6)	(17.3)	(15.1)	(8.2)	(9.0)	(9.8)	(11.5)
Trade balance	(27.9)	(28.7)	(29.7)	(25.5)	(26.5)	(26.2)	(26.7)
Net foreign direct investment	9.7	10.0	11.1	9.8	6.7	7.4	7.0
(% of current account receipts, unless noted otherwise)							
Current account balance	(40.9)	(36.1)	(31.0)	(18.1)	(19.3)	(21.2)	(25.5)
Gross external debt	32.8	27.7	30.8	43.5	43.8	42.6	41.4
External debt, net of liquids assets	17.7	15.0	15.5	18.7	22.1	22.9	25.0
Net public-sector external debt	(5.01)	(3.56)	(3.59)	(1.75)	0.48	1.87	4.55
Net financial-sector external debt	22.7	18.6	19.1	20.5	21.6	21.1	20.5
Gross external financing needs (% of CARs and usable reserves)*	144.7	145.6	152.2	134.9	133.6	138.4	146.2
Usable reserves/current account payments (months)	(0.02)	(0.17)	(0.54)	(0.25)	(0.01)	(0.25)	(0.39)

*Gross external financing needs are defined as current account outflows plus short-term debt by remaining maturity. Usable reserves are adjusted for 100% of the monetary base. e--Estimate. f--Forecast. CARs--Current account receipts.

More modest current account deficits

We expect that the CAD declined to 8.2% of GDP in 2009 (from 15% of GDP in 2007-2008). Lower FDI inflows, weak consumer demand, and lower oil prices brought down the trade deficit to 25% in 2009 from 30% of GDP in 2008. We project the trade deficit and CAD in 2010 to be 26% and 9% of GDP on still modest capital goods imports associated with the slowdown in the development of tourism projects.

Chart 11



Traditionally, FDI has financed a large part of the CAD. From 2005-2008, FDI financed almost two-thirds of the CAD. In the first three quarters of 2009, FDI inflows were greater than the CAD. However, we believe that in 2010 and over the following several years, FDI will not fully finance the deficit (in line with its historical pattern). FDI totaled US$600 million during the first nine months of 2009, compared with US$1 billion in full-year 2008. We expect FDI to slow further in 2010 as tourism projects progress slowly. As we mentioned earlier, the FDI projects that appear to have staying power are those that eventually will serve high-end customers or a niche group of tourists, as well as those that will provide residential tourism products.

Higher external public-sector debt

Gross external public-sector debt increased sharply in 2009 with a US$300 million private placement in November. Until 2009, generally stable public-sector external debt meant the private sector provided the financing for the CAD (mostly in the form of FDI) or errors and omissions in the balance of payments account. The presence of persistently large positive errors and omissions substantially complicates the analysis of the CAD financing and the country's overall external balance sheet. Errors and omissions were 24% of CAD in 2007 (and were as high as 85% of CAD in 2004). Standard & Poor's estimates that errors and omissions most likely represent the underreported FDI or tourism inflows and thus qualitatively diminish liquidity risks, as the officially large external current account position demonstrates. However, in the first nine months of 2009, errors and omissions were slightly negative.

Chart 12

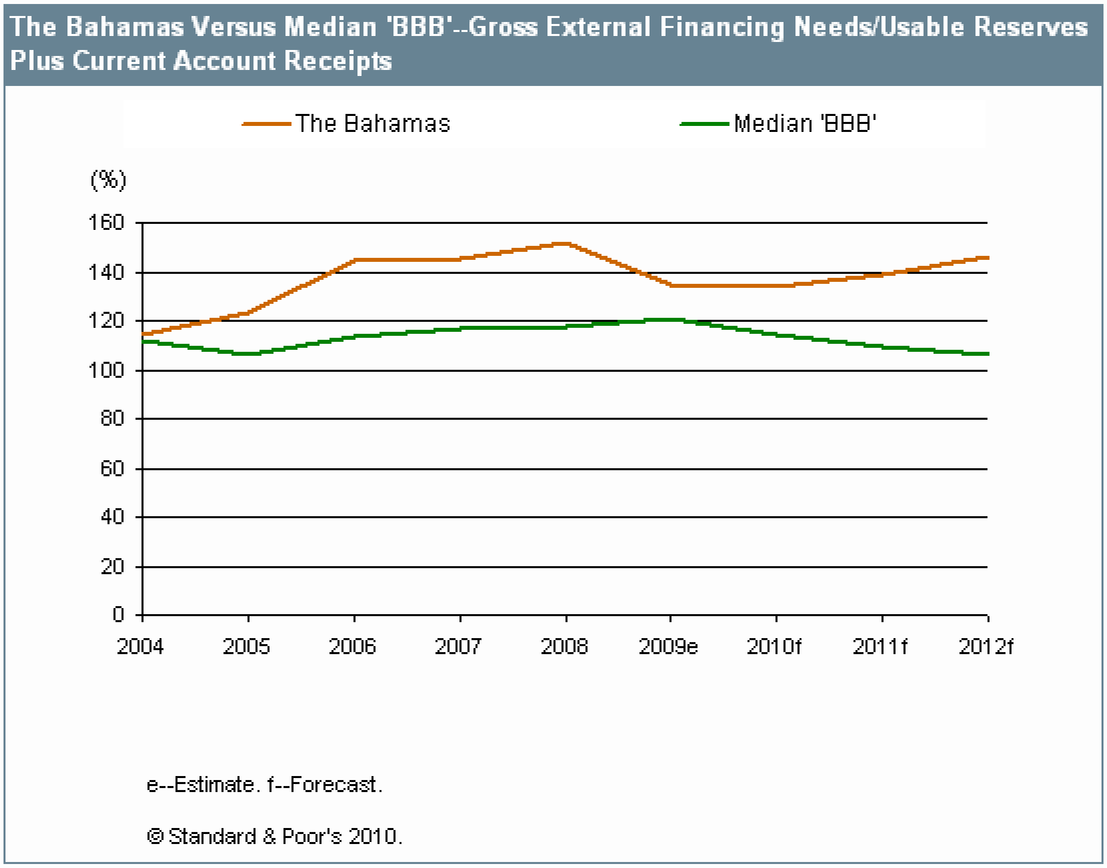
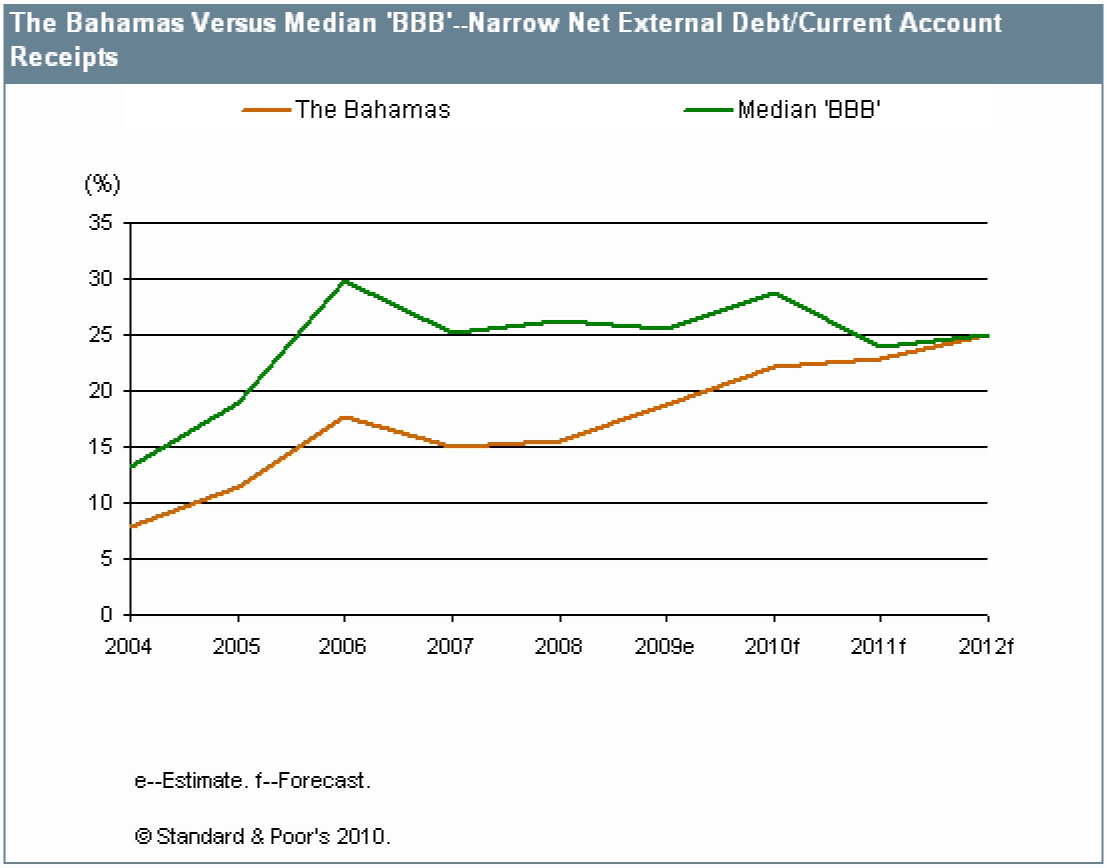

The Bahamas Versus Median 'BBB'--Gross External Financing Needs/Usable Reserves Plus Current Account Receipts
The Bahamas
Median 'BBB'
(%)
160
140
120
100
80
60
40
20
0
2004
2005
2006
2007
2008
2009e
2010f
2011f
2012f
e--Estimate. f--Forecast.
© Standard & Poor's 2010.

Chart 13



International reserves increased substantially in 2009 to US$825 million from US$563 million at year-end 2008. Reserves performed well given the stagnant economy and limited demand for credit. But, they received a particular boost in the second half of 2009, when they usually experience a seasonal drop. A few factors are responsible for the increase in international reserves, including the proceeds of public-sector borrowing, namely a US$300 bond issue/private placement due in 2029, and US$178.7 million in special drawing rights under the global IMF initiative (SDRs are international reserve assets created by the IMF and are potential claims on the freely usable currencies of IMF members). In addition, The Bahamas had an extraordinary tax-related foreign exchange inflow in November relating to the sale of a large commercial entity.

External liquidity needs are high, though lower than they have been in the past several years (given a lower CAD and higher level of reserves). Liquidity needs incorporate the mostly short-term nature of the banks' external liabilities. Last year, the Bahamas' gross external financing needs were 135% of CAR and usable reserves (adjusted for reserves needed to support the currency peg). We project that external liquidity needs should remain near that level in 2010-2011. The public sector's external debt service is low. Three international bonds, which the central government issued for a total amount of US$600 million and that mature in 2029, 2033, and 2038 , constitute 85% of public-sector external debt. Gross public-sector external debt more than doubled to 23% of CAR in 2009. We expect the gross external debt-to-CAR ratio to decline slightly over the next several years. However, net public-sector debt likely will rise slightly as international reserves decline. The banking sector is a net external debtor, with liabilities at 20% of CAR on a net basis in 2009. The size and profile of the external debt of the

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nonfinancial private sector is not available, but we assume the debt level is low, given the sector's capital controls.

Ratings Detail (As Of April 28, 2010)*	
Bahamas (The Commonwealth of The)	
Sovereign Credit Rating	BBB+/Stable/A-2
Senior Unsecured (3 Issues)	BBB+
Sovereign Credit Ratings History	
23-Dec-2009	BBB+/Stable/A-2
24-Nov-2008	A-/Negative/A-2
28-Jan-2008	A-/Stable/A-2
01-Aug-2007	A-/Positive/A-2
Default History	
None since 1975	
Population	338,000 as of 2008
Per Capita GDP	Estimated US$21,449 in 2009
Current Government	
Prime Minister Hubert A. Ingraham, head of the ruling Free National Movement	
Election Schedule	
House of Assembly Most recent: May 2007 Next: by May 2012	

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.