



Press release 2015-011

“Provides perverse incentives” **Central bank president cautions about standing subscription**

WILLEMSTAD/PHILIPSBURG - “The standing subscription, entailing that the governments of Curaçao and Sint Maarten can borrow at the interest rates prevailing in the Dutch capital market, provides perverse incentives,” President of the Centrale Bank van Curaçao en Sint Maarten Emsley Tromp warned in his policy recommendations in the Bank’s annual report for 2014.

Tromp explained that while there was an improvement in the balance of payments, “this improvement should be interpreted with caution.” He pointed out that although there was a significant increase in the gross official reserves of the monetary union, resulting in a rise of the import coverage, “the increase in the gross official reserves was to a large extent related to the issuance of bonds by the governments of Curaçao and Sint Maarten bought by the Dutch government. If corrected for the inflow of funds related to these bond issuances, the import coverage would have been 3.5 months in 2014 instead of the initial 3.9 months.” He further cautioned that “although the import coverage would have remained above the 3 month benchmark, it can be concluded that, based on economic performance alone, our balance of payments would not have improved.”

Elaborating on the perverse incentives of the standing subscription, Tromp outlined three reasons why the standing subscription gives such incentives. “First, it gives an incorrect price signal. Under normal circumstances, government bond yields include country-specific risk premiums. Consequently, increasing indebtedness causes bond yields to go up, increasing the cost of borrowing and imposing fiscal discipline on governments,” he said. “This discipline is particularly important in a monetary union with an exchange rate peg, where there is little scope for monetary sterilization. However, because of the standing subscription agreement, the government bond yields in Curaçao and Sint Maarten do not reflect the risk premiums of either country but the much lower risk premium of the Netherlands.

“Second, the standing subscription leads to a misallocation of resources,” Tromp continued. “According to the standing subscription rule, the Dutch State Treasury Agency (DSTA) is legally obliged to bid on the debt securities issued by the two countries for the full requested amount. As the interest rates prevailing in the Dutch capital market are significantly lower than those based on the economic fundamentals in Curaçao and Sint Maarten, the main players in our local capital market, i.e., the banks and institutional investors, are in fact

excluded because the yields do not reflect our economic realities.” In the meantime, the capital market in Curaçao and Sint Maarten has been characterized for some years now by high excess liquidity and a lack of investment opportunities, Tromp explained.

“Third, under the current agreement, the interest burden rule is used as a benchmark to assess whether Curaçao and Sint Maarten are allowed to borrow,” he added. “However, this interest burden rule is not a prudent benchmark for assessing debt sustainability, primarily because the current low cost of borrowing will not be permanent. Therefore, the debt-to-GDP ratio must also be taken into consideration in the decision to borrow to prevent unsustainable debt servicing in the future,” Tromp said.

Since attaining the status of autonomous countries in the Dutch Kingdom, both Curaçao and Sint Maarten have seen their debt-to-GDP ratios increase rapidly. Although these ratios are still relatively low compared to other countries in the region, Tromp urged Curaçao and Sint Maarten to be cautious “lest their debt ratios become unsustainable again. In Curaçao, growth has been lackluster over the past several years. If the country’s poor economic performance continues, servicing debt in the future might soon become a challenge.”

In the case of Sint Maarten, Tromp said that “it can be concluded that the price of becoming an autonomous country was inheriting part of the public debt of the former Netherlands Antilles, as Sint Maarten was not allowed to borrow before October 10, 2010. Sint Maarten can now borrow to finance investments, but tax revenues have been rising only marginally. Hence, the question rises whether Sint Maarten will be able to cover its current expenditures while complying with its debt obligations in the future.”

The central bank president suggested that given the risks of unsustainable debt levels in the near future, the authority of the Curaçao and Sint Maarten governments to borrow should be reconsidered except in extraordinary situations. “Thus, the current golden rule stating that the current account of the budget must be at least in equilibrium, should be expanded. When the governments can no longer borrow anymore, capital expenditures should be financed by surpluses on the current account of the budget. The overriding criterion to deviate for this rule would be in the case of a significant adverse external shock that negatively affects the economy by, for example, more than 5% of GDP,” Dr. Tromp concluded.

Willemstad, July 15, 2015

CENTRALE BANK VAN CURACAO EN SINT MAARTEN