Monetary policy and financial sector supervision - options for the islands of the Netherlands Antilles

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Location: Bank van de Nederlandse Antillen, Curaçao, 21 December 2005.

1. I am glad to accept the invitation to speak here today, which in my view reflects the excellent relations between our two central banks. Governors Tromp and Wellink and other board members meet regularly to discuss issues of common interest, and over the years there have been numerous exchanges of staff with expertise in the fields of prudential supervision and monetary policy implementation. My own most recent involvement with the Netherlands Antilles concerned the question whether it would be beneficial for the islands to pursue the status of ultraperipheral region of the EU. I was a member of the Committee European Union, presided by Ronald van Beuge, which was established to explore the possible future relations of the Netherlands Antilles and Aruba with the EU. The Committee concluded that the disadvantages of being part of the EU outweighed the advantages for the Netherlands Antilles and Aruba. This assessment was primarily based on economic considerations, but political considerations could potentially lead to a totally different conclusion. Therefore, I will also consider this option in my talk today.

2. My contribution takes place against the background of the current constitutional reform of the Netherlands Antilles into separate island territories. As was agreed during the Round Table Conference of 26 November, the targeted outcome of the reform is for Curaçao and St. Maarten to become autonomous states within the Kingdom of the Netherlands, while Bonaire, Saba and St. Eustatius are expected to strengthen their direct ties with the Netherlands. Therefore, the current tasks of the Netherlands Antilles will have to be transferred in some way to the new separate island entities, although the islands can perform certain tasks jointly if they wish. Given my area of expertise, I will focus on the options concerning the design of the monetary policy and financial sector supervision framework for the islands in their new constitutional setting. Let me first clarify that it is not my intention to prescribe the optimal solution for the islands, but merely to point out the consequences of each option as I see them. Furthermore, these options are not just the fantasies of a central banker: the islands themselves also recognise most of them in their recent joint report “Future in sight!”.

Considerations regarding monetary policy and financial supervision in small island economies

3. Before turning to the specific options for the monetary policy and financial supervision framework, I think it is useful to think first about the criteria these options should satisfy. In my opinion, these criteria are credibility, independence, professionalism, efficiency and political support. Professionalism, credibility, and independence are interrelated, and have to do with the necessity for a central bank to be recognised as a financial authority that knows what it is doing and is trustworthy in its intentions. The reputation of a central bank is so important because monetary policy decisions affect the economy mainly through their influence on private sector expectations. Efficiency is a criterion mainly because a central bank is indirectly financed by tax-payers’ money. Putting the government finances in order is currently one of the main priorities for the Netherlands Antilles, and it would be helpful if the monetary policy and prudential supervision framework contribute to this effort. The last general criterion I mentioned, political support, may sound obvious, but its importance should not be underestimated. Irrespective of the degree of independence of the central bank, without sufficient political support neither a currency peg nor a monetary union would be viable in the long run, since both need to be supported by sound macro-economic policies.

4. Apart from these general criteria, the options should of course also be suitable for small island economies. An important characteristic of such economies in this context is their openness to trade. As it is impossible for a small island to produce a large range of different goods themselves, they usually rely heavily on imports. This implies that large movements of the exchange rate will be especially harmful for small island economies, since they will feed through into the domestic price level relatively quickly. Moreover, the uncertainty related to exchange rate volatility would make it costly to invest in the export-oriented markets, such as tourism. All in all, exchange rate stability vis-à-vis the main trading partners is an important asset for small island economies.

5. The current monetary policy framework reflects the importance of exchange rate stability. The Bank van de Nederlandse Antillen has kept the exchange rate of the Antillean guilder stable against the dollar for almost thirty-five years, which is an extraordinary accomplishment given the at times highly adverse macro-economic conditions. The reason for pegging to the dollar is the fact that over 60% of the international trade relations of the Netherlands Antilles is conducted with the United States or in US dollars. In other words, the economy is predominantly dollar-oriented. As a result of the credible dollar-peg, the inflation rate closely followed the American inflation rate over the years, thereby keeping the competitiveness position of the Netherlands Antilles fairly stable.

6. Besides monetary policy, prudential supervision on the financial sector currently also functions well. The IMF declared banking and insurance supervision as compliant or largely compliant with the Basel and IAIS Core Principles and called BNA staff highly capable, well-trained and dedicated. With this point of departure in mind, I will now discuss three options for the monetary policy framework for the island territories of the Netherlands Antilles, and then focus on the design of financial sector supervision. These three options are, first, forming a monetary union, second, establishing separate central banks and currencies, and third, introducing an existing currency like the dollar or the euro.

Option 1:Forming a monetary union

7. Since the current situation is working well, the islands could consider changing it as little as possible. This would be done by forming a monetary union, in which the BNA can be transformed into the common monetary authority, keeping the peg of the Antillean guilder to the dollar unchanged. The advantage of this option is that most of the criteria I mentioned before are satisfied. First, it is a suitable option for small island economies, given that the valuable exchange rate stability is not likely to be jeopardised. Furthermore, the BNA is clearly a credible and professional institution, not only because the IMF says so, but also because it otherwise would not have been able to keep the exchange rate stable for over thirty years. It is also a relative efficient option, since there are economies of scale in performing the monetary tasks jointly.

8. The main issue regarding this option is the political support, and related to that the solidness of the constitutional arrangements between the islands. The acceptance and support by the islands of the monetary union and the independence of the common central bank is a precondition for a viable monetary union. To secure the support if this option is chosen, a politically agreed statute for the monetary union would preferably be embedded in the new Charter for the Kingdom of the Netherlands. Political support is especially important since the participants in a monetary union need to agree on and adhere to rules for fiscal policy, in order to prevent that large budget deficits of one island frustrate the common monetary policy. Of course, the current high debt situation in the Netherlands Antilles cannot be properly solved in a sustainable way without strict fiscal rules either. A rule based fiscal policy that deliberately limits political discretion should be in place anyway!

Option 2: Establishing separate central banks and currencies

9. Instead of forming a monetary union, particularly the larger islands have the option to establish their own central banks and currencies and conduct monetary policy individually. In order to preserve exchange rate stability, the new currencies would preferably also be pegged to the dollar or to a basket of currencies reflecting the trade relations of the islands concerned. In this option, the smaller islands could either choose to join in a monetary union with one of the larger islands, or to introduce another existing currency like the dollar or the euro.

10. When evaluating the pros and cons of this option, the islands should realise that a trade-off exists between having monetary policy autonomy (which in practice is already limited by the currency peg) and the efficiency and effectiveness of monetary policy. Introducing new currencies and establishing new central banks are costly affairs. Moreover, the newly created central banks will not automatically inherit the credibility the BNA has acquired over the years. This means that these central banks will have to put a lot of energy into proving their independence and establishing a reputation of credibility. Especially the first years, maintaining a currency peg can prove to be difficult, because the financial markets may want to test the ‘true’ intentions and independence of the new central banks.

Option 3: Introduction of the dollar or the euro

11. Given that the Netherlands Antilles are highly dollar-oriented economies, (some of) the islands can also choose to introduce the dollar as legal tender. This will guarantee complete exchange rate stability against the main trading partner, thereby satisfying the criterion of being suitable for small island economies. Furthermore, by introducing the dollar the islands would automatically import the credible monetary policy of the US Federal Reserve. Also in terms of cost-efficiency this option scores relatively well, since establishing new central banks is not necessary. At the same time, however, seigniorage earnings will come to an end.

12. The pros and cons of introducing the euro are similar to introducing the dollar, except for one big difference: introducing the euro would create more volatility in the trade-weighted exchange rate and therefore in the economy. Since trade predominantly takes place in US dollars, with the euro being a distant second, exchange rate stability against the dollar is more beneficial for the economy than exchange rate stability against the euro. Having said that, however, the example of Saint Martin proves that having the euro as legal tender does not have to be problematic

even in this part of the world, if the euro is part of a Europe-oriented political strategy. Such a political strategy would probably involve obtaining the status of ultraperipheral region of the EU, as Saint Martin has done. In view of the existing European legislation, the responsibility for monetary policy would in that case be transferred to the European System of Central Banks, and the Nederlandsche Bank would be charged with the implementation of monetary policy. Finally, the European fiscal rules as laid down in the Stability and Growth Pact would then apply to the public finances of the Kingdom of the Netherlands as a whole, which necessitates some kind of agreement on fiscal discipline within the Kingdom to prevent the accumulation of public debt.

13. As a result of a Europe-oriented strategy and the introduction of the euro, the trade patterns of the islands could start to shift in the direction of the EU, thereby increasing the suitablility of the euro for the Antilles. This switch towards European markets will require considerable effort and will probably be a slow process. Until this process is sufficiently advanced, the islands will be more vulnerable to economic shocks than under their current dollar-peg.

Financial sector supervision

14. How could the supervision of the financial sector be designed under these different monetary policy options? Besides the question whether to centralise or decentralise, here also the issue of whether to entrust it to a central bank or to a separate supervising authority comes into play. To start with the latter, an advantage of placing prudential supervision in the hands of a central bank – besides efficiency – is the fact that the central bank also functions as a lender of last resort in case the financial sector experiences a sudden liquidity problem. In other words, by making a central bank responsible for prudential supervision, the institution that has to solve problems once they occur is also responsible for preventing these problems in the first place.

15. With regard to the degree of centralisation, I think this partly follows from the monetary policy framework chosen. For instance, in case a monetary union is formed, it seems logical to entrust the common central bank with the supervision of the financial sector on all the islands. Alternatively, if some of the islands establish new central banks, these could also be entrusted with the financial sector supervision on the respective island. Of course, breaking up prudential supervision only reinforces the loss of efficiency that would argue against this option. Furthermore, it creates the need for a well-organised information sharing arrangement between the different supervisors in order to contain systemic risks, since problems in one financial institution can easily spread out and affect the stability of the financial system on other islands. With regard to the third option, (unilaterally) introducing the dollar or the euro would in my view increase the benefits of a centralised prudential supervision framework. After all, a lender of last resort in that case no longer exists, which actually is one of the main drawbacks of this option. This creates an even stronger need for establishing a well-organised and professional prudential supervision framework with a minimum of information-sharing problems, which is most easily realised by carrying out supervision jointly, either through the experienced BNA or by a newly established common institution.

Concluding remarks

16. What should be the conclusion of my discussion of options concerning monetary policy and prudential supervision? I would say the main message is that it all depends on the degree of political support, and the way this support can be translated into solid constitutional arrangements. For instance, if the islands support a Europe-oriented strategy, they could choose the euro. If they accept fiscal rules and the independence of the common central bank, they could choose a monetary union. I have merely tried to point out the consequences of the options as I see them.