Balance of payments vulnerabilities caused by a widening current account deficit: a way forward. Is dollarization the right approach?

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So much of barbarism still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own.

John Stuart Mill (1848)

Outline presentation

- Background
- Analysis balance of payments
- The definition of dollarization
- Benefits and costs of dollarization
- Requirements for successful dollarization
- Implications of dollarization for the tasks of the central bank
- Conclusion

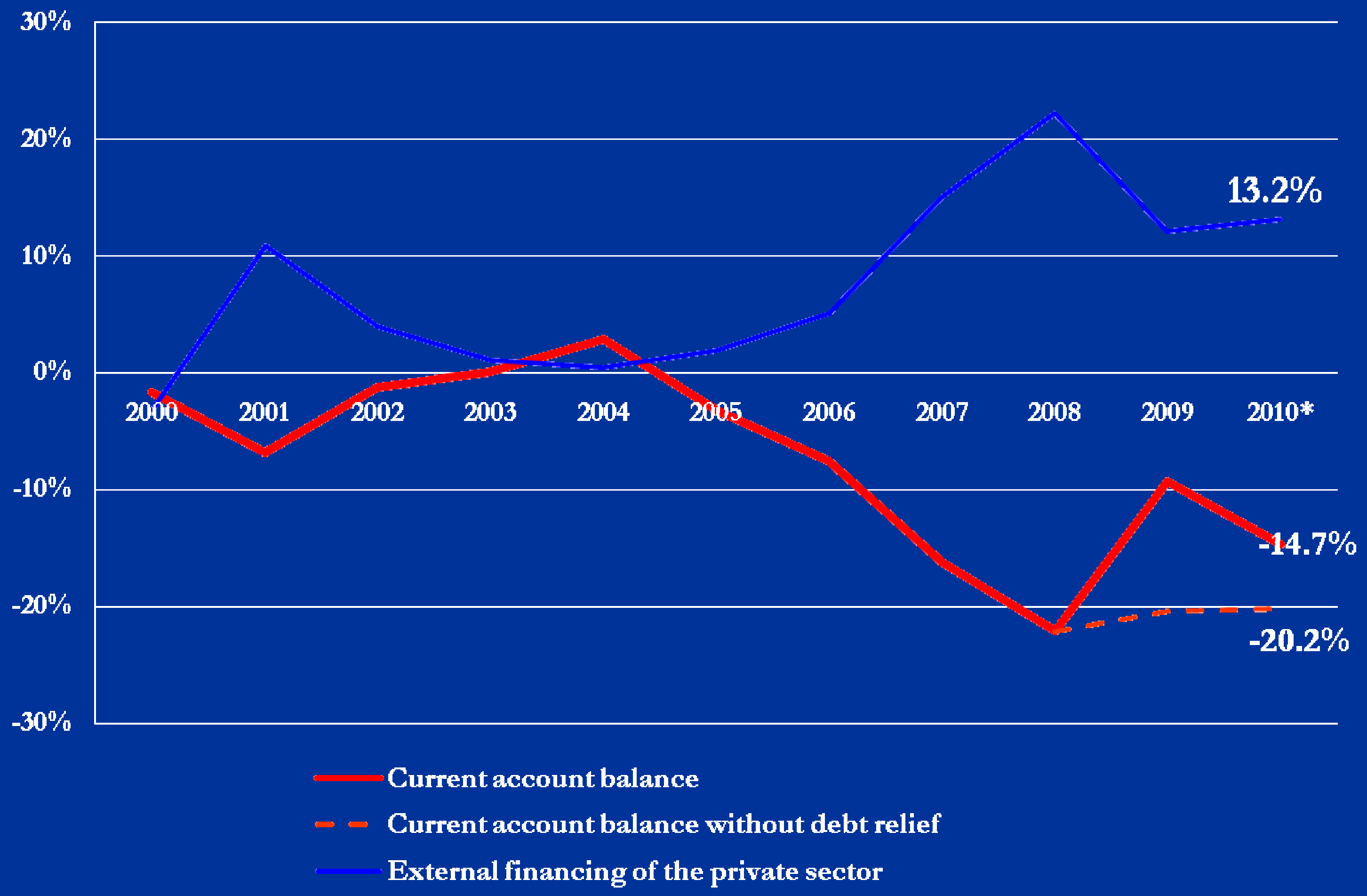
Background (1)

- **Constitutional changes within the Dutch Kingdom:**
  - **Bonaire, Saba and St. Eustatius introduced the US dollar as legal tender on January 1st, 2011.**
  - **Curaçao and St. Maarten currently form a monetary union with one central bank and a common currency.**

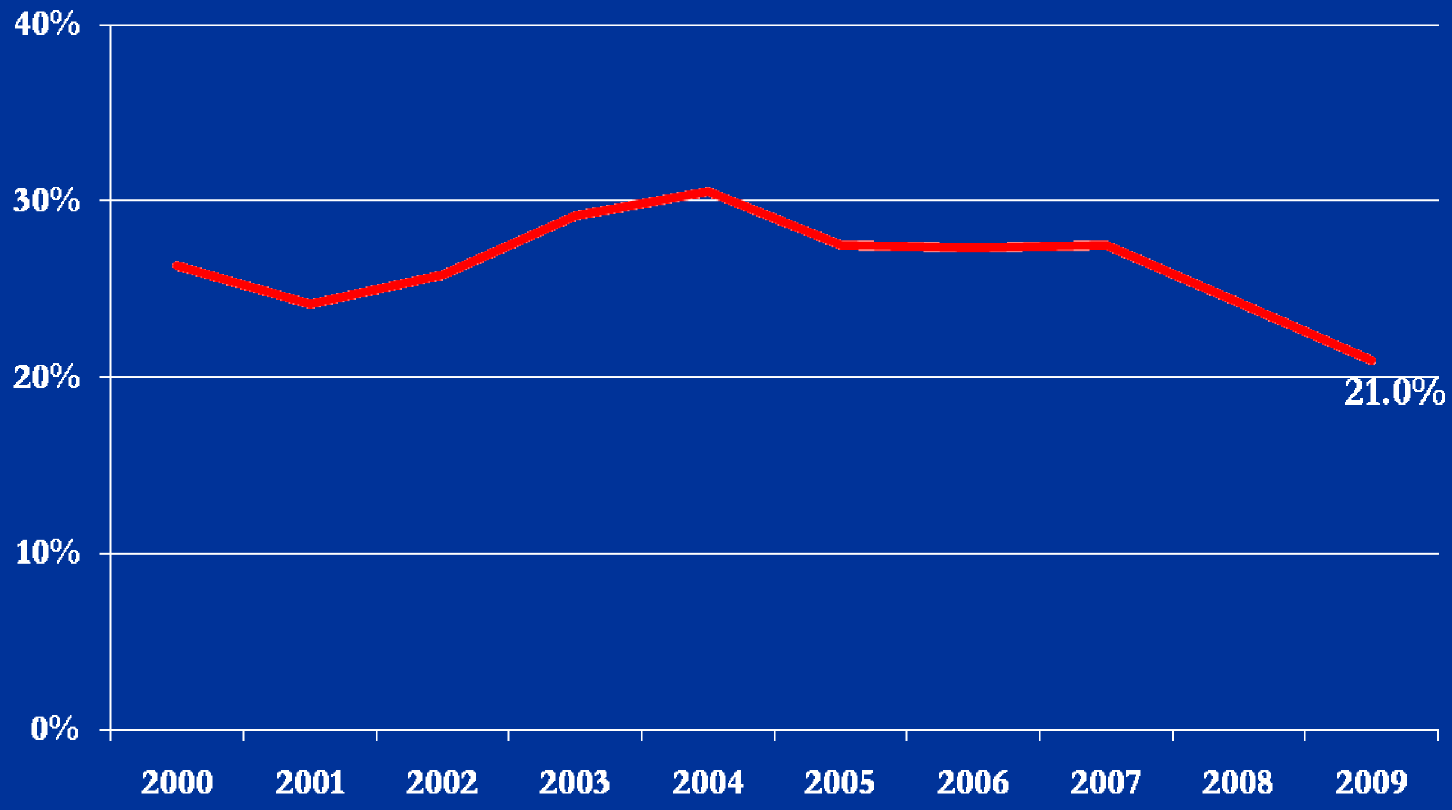
Background (2)

- Limited ability of small open countries to deal with external shocks:
  - Lessons from the recent international financial crisis (40 – 60 rule).
  - Increased vulnerabilities due to:
    - Loss of economies of scale after 10/10/2010.
    - Widening current account deficit of the balance of payments.

Balance of payments development
(in % of GDP)



Development
external debt-to-GDP ratio



Scenario without debt relief

	WITH DEBT RELIEF			WITHOUT DEBT RELIEF	
	2009	2010		2009	2010*
Current account	-669.3	-1,080.7		-1,456.9	-1,487.5
Capital account	200.6	90.7		200.6	90.7
External Financing	873.4	970.5		1,373.8	1,301.6
Direct investments	-196.2	198.5		196.2	90.7
Loans and credits	706.3	1,263.2		1,116.1	1,168.7
Portfolio investments	-188.9	-215.6		61.3	-65.6
Change in reserves	-538.9	-116.3		-252.0	-41.3

The development of our balance of payments increases our vulnerabilities

- **Exchange rate adjustment and inflation resulting from a sudden reversal of capital inflows.**
- **Inability to meet foreign obligations.**
- **Loss of credit worthiness.**

Present situation: Pegged exchange rate system (1)

- Stable peg Netherlands Antilles guilder to US$ since 1971.
- Monetary policy aimed at ensuring sufficient reserves to maintain the peg.
- Central Bank has discretionary power to manage monetary base, i.e., monetary sterilization.

Present situation: Pegged exchange rate system (2)

- Globalization has led to:
  - Increased trade flows
  - Increased capital flows

- Balance of payments vulnerabilities have increased

- Share of countries with exchange rate peg has fallen over past 15 years.

The definition of dollarization

- Informal dollarization
- Semi-formal dollarization
- Official dollarization
  - In the case of Curaçao and St. Maarten: adoption of the US$ as the legal tender.

Why do countries dollarize?

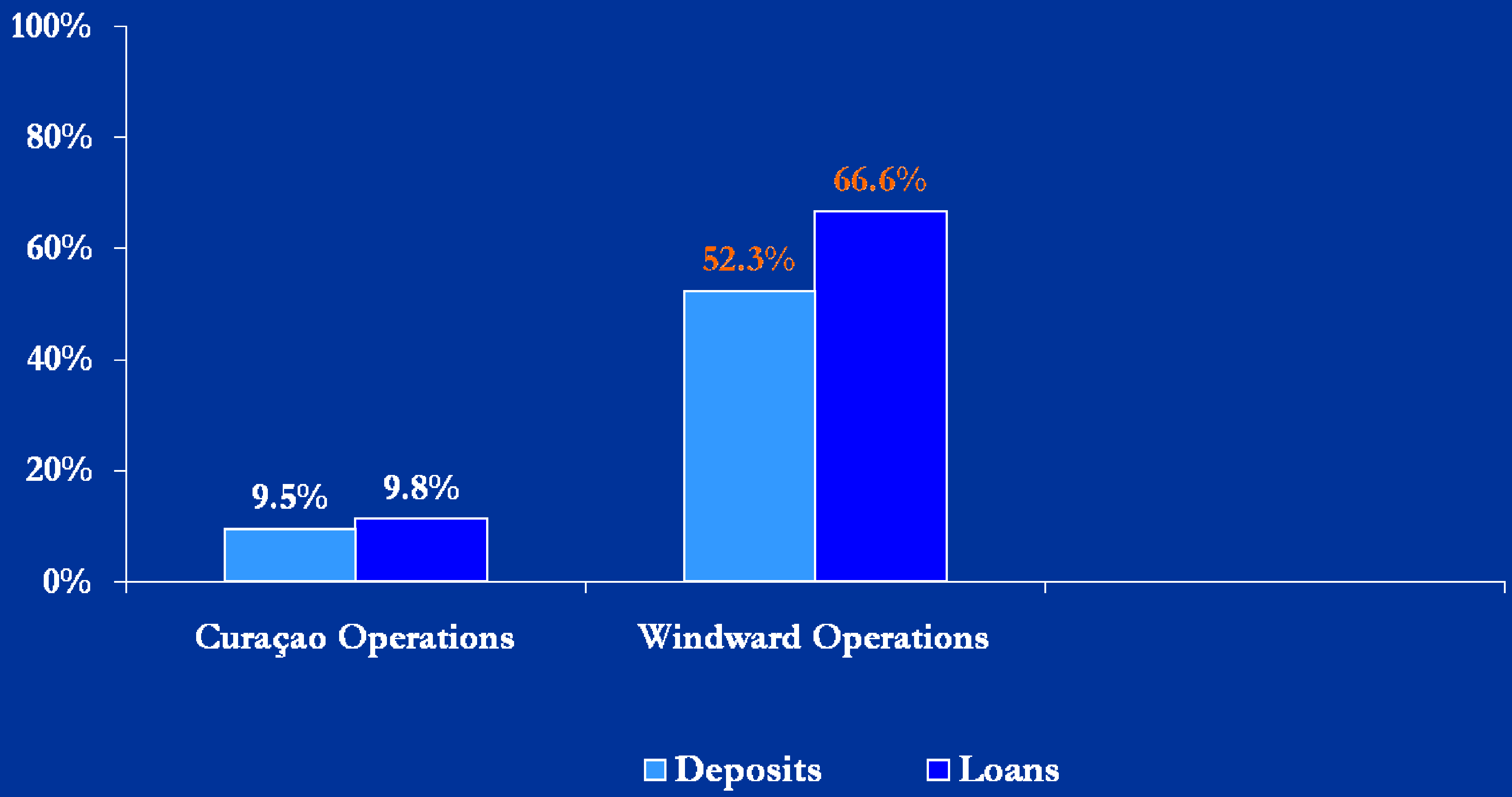
International experience learns that countries dollarize to promote policy credibility:

- Reduce inflation and bring macro-economic stability (e.g. Ecuador)
- Promote integration with international markets (e.g. El Salvador)

Characteristics dollarized economies

- The size of the economy is small.
- The economy has a high degree of openness.
- The economy suffered from monetary instability and rapidly expanding inflation.
- The economy was already de facto dollarized.

Share foreign exchange in total deposits and loans



Benefits of dollarization

- Elimination currency risk / reduction default risk.
- Lower transaction costs.
- Promotion of the soundness of the financial sector.
- Integration in international financial markets.
- Promotion of macroeconomic stability by constraining monetary financing of fiscal deficits.
- Promotion of economic growth.

Costs of dollarization (1)

- No possibility of autonomous monetary and exchange rate policy
  - Limited possibility given the current peg.
  - More dependent on fiscal policies and structural measures.

Costs of dollarization (2)

Loss of government income

– Seigniorage revenues	NAf.17.7 million.
– Licence fee revenues	<u>NAf.72.2 million</u>
Total	NAf.89.9 million

Continued

However, in the absence of balance of payment constraints, the Central Bank's gold and capital & reserves will become investable funds. Moreover a "Transaction fee" can be charged on all transactions between residents and non residents.

Transaction fee	**NAf. 122.2 mln**
Return on capital and reserves investments	**NAf. 20.6 mln**
Return on gold investments	**NAf. 30.0 mln**
Total	**NAf.172.9 mln**

Costs of dollarization (4)

- Loss of lender-of-last resort function
  - Foreign banks act as lender-of-last resort for subsidiaries.
  - Setup of contingent credit lines.
  - Deposit insurance scheme.

Traditional lender-of-last resort function has become an illusion!

Requirements for successful dollarization(1)

- The local currency is successfully pegged to the anchor currency.
- Reserve coverage of the monetary base.
- The domestic banking sector is functioning well and supervision is adequate.
- The fiscal deficit and outstanding public debt are low.

Requirements for successful dollarization (2)

- **Capital mobility is ample, in particular foreign direct investments (FDI).**
- **Broad acceptance.**

Implications for the tasks of the central bank (1)

- **Promoting a stable value of the NAf. with respect to the US dollar:**
  - **Becomes obsolete.**
- **Managing the foreign exchange reserves:**
  - **Adjusted: investing freed up capital and reserves. Issuing of licenses for foreign exchange transactions becomes obsolete.**
- **Issuing paper money and circulation of coins:**
  - **Adjusted: managing the supply of US$ notes and coins.**

Implications for the tasks of the central bank (2)

- Safeguarding the soundness of the financial system:
  - Adjusted: broadened to compensate for the loss of the lender-of-last resort function.
- Promoting a reliable payment system:
  - Remains the same.

Implications for the tasks of the central bank (3)

- Acting as the government's banker
  - Remains the same.
- Serving as one of the government's main advisors on financial and economic affairs
  - Adjusted: broadened as fiscal policy and structural measures will become crucial.

Conclusion

- Conventional wisdom is that countries dollarize in order to restore monetary stability and to impose fiscal discipline.
- However, the lessons learnt from the 2008 great recession have served to drive home the fact that we are susceptible to other kinds of risks including balance of payments risk and supervisory risks.

Conclusion

- Dollarization is a viable alternative monetary system for Curaçao and St. Maarten, as it eliminates the balance of payments risk.
- Hence in our case, dollarization is not a prescription for inflation but a measure to protect us from perils and promote sound and sustainable economic growth.

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Thank you for your attention