

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



February 8, 2011

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)

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Outline presentation

- **Background**
- **Why dollarize:**
 - Vulnerabilities
 - Development balance of payments
- **Benefits and costs of dollarization**
- **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:**
 - **Increased vulnerabilities due to:**
 - **Loss of economies of scale after 10/10/2010.**
 - **Widening current account deficit of the balance of payments.**
 - **Lessons from the recent international financial crisis.**

Increased vulnerabilities

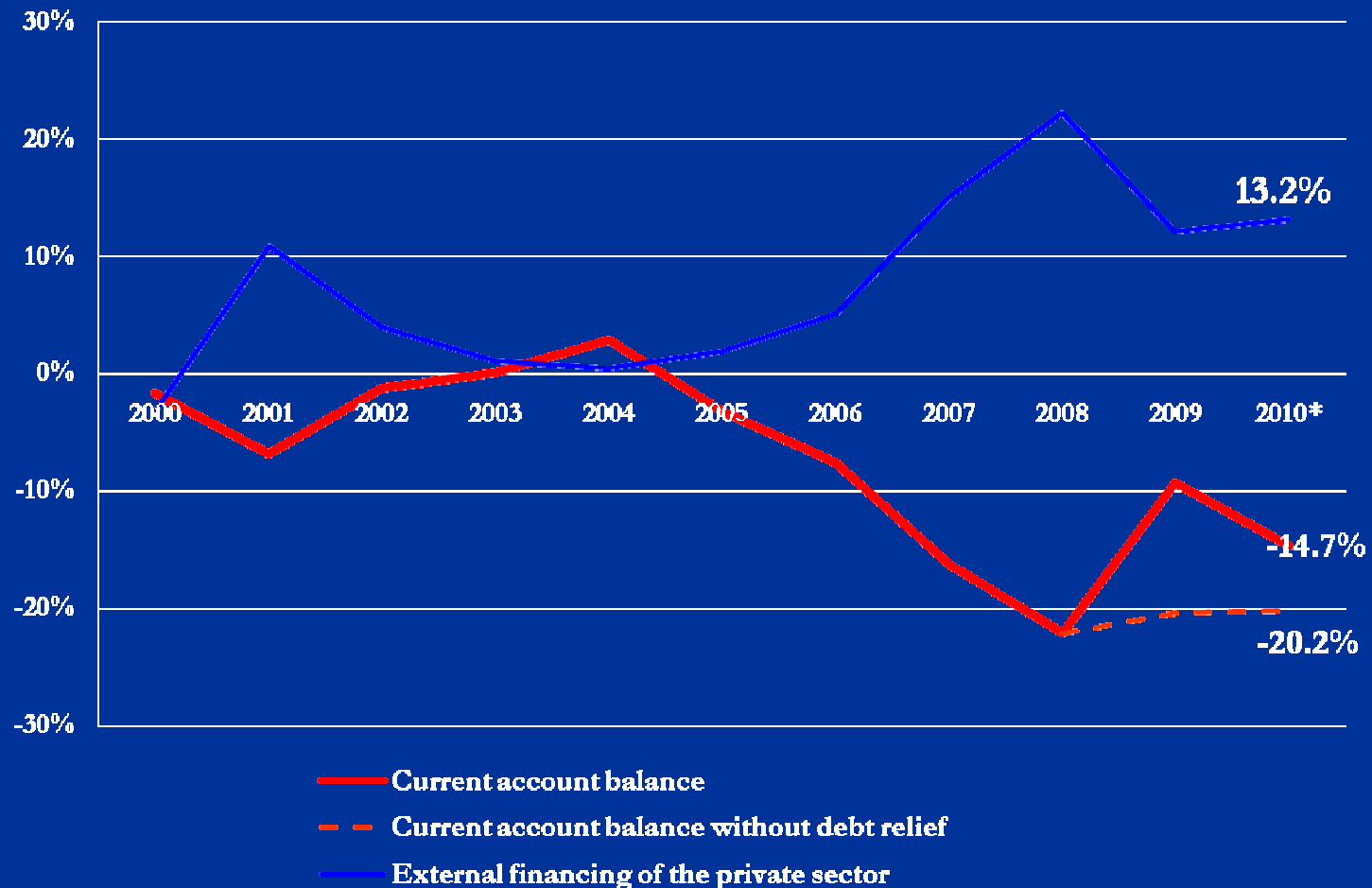
(in mln Naf.)

	GDP
CURACAO	5,300
SINT MAARTEN	1,500
TOTAL	6,800

	Total assets
MCB	5,600
GIRO	1,100
RBTT	3,900
BDC	1,400
APNA	4,200
FATUM	900
ENNIA	1,100

FOREIGN RESERVES (EXCL. GOLD)	1,900
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Balance of payments development (in % of GDP)



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.

...however, situation has been mitigated

- **Investment rule**
- **Implementation debt relief**

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
<i>Direct investments</i>	-196.2	198.5		196.2	90.7
<i>Loans and credits</i>	706.3	1,263.2		1,116.1	1,168.7
<i>Portfolio investments</i>	-188.9	-215.6		61.3	-65.6
Change in reserves	-538.9	-116.3		-252.0	-41.3

Dollarization

Dollarization is recommended in order to:

- Reduce vulnerabilities
- Make economic growth the overriding objective

Why did 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)

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 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	<u>NAf. 30.0 mln</u>
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!**

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**